S. HRG. 108–238

# SBA REAUTHORIZATION: CREDIT PROGRAMS (PART II)

## ROUNDTABLE

BEFORE THE

## COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

MAY 1, 2003

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ONE HUNDRED EIGHTH CONGRESS

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# CONTENTS

COMMENTS FOR THE RECORD



*Comments (if any) between pages 2 and 93.

# SBA REAUTHORIZATION: CREDIT PROGRAMS (PART II)

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**THURSDAY, MAY 1, 2003**

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP,
*Washington, D.C.*

The Committee met, pursuant to notice, at 9:38 a.m., in room SR–428A, Russell Senate Office Building, Hon. Olympia Snowe (Chair of the Committee) presiding.

Present: Senator Snowe.

## OPENING STATEMENT OF OLYMPIA SNOWE, CHAIR, SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, AND A UNITED STATES SENATOR FROM MAINE

Chair SNOWE. Since time is of limited duration here—I have a vote at 10:15 and conflicting markups—we will begin and I will dispense with much of my opening comments. Suffice it to say that I truly appreciate the fact that you are all here this morning to continue this dialogue regarding the upcoming reauthorization of the Small Business Administration (SBA). This has been very helpful to me as new Chair of the Committee on Small Business and Entrepreneurship. Senator Kerry and I will be working on some of these issues together.

This has been very instructive for me in this process, so I really appreciate your helping to continue this discussion. Today, obviously we will be concentrating on the 504 program, the disaster loan program, the venture capital programs that include small business investment companies, and the New Market Venture Capital program, all of which have been extremely effective and successful programs that have played a pivotal role in the growth of our economy and the growth of small business.

Just looking at the numbers in the 504 loan program, in the past 3 years, the SBA has provided guarantees for more than 15,000 new loans through the 504 loan program, almost 3,000 for new business startups and more than 12,000 for existing small businesses. The total number of jobs created and retained as a result was 325,471 jobs during the 3-year period, which I think underscores the value of this program to small businesses and to our overall economy.

Obviously, the SBA's venture capital programs have also been extremely effective, particularly at a time as you well know, that lending institutions have had to ratchet back availability to small businesses in particular because of the stock market bubble burst. As a result, it has been much harder for small businesses to access

venture capital. That is where these programs have really come in to play. In fact at a time in which venture capital firms have decreased their investments, the number of SBICs have increased. There are now 443 licensed SBICs and they have made more than 16,000 investments in small businesses since the start of fiscal year 1999 with a total of more than $17 billion in value. Clearly they have played a critical role in the creation and retention of almost a half-million jobs during this period of time.

SBA's disaster assistance program, obviously, is their foremost direct lending program. In the wake of the terrorist attacks on September 11th, the SBA approved more than 11,700 business disaster loans to businesses across the country with a total volume of more than $1.1 billion.

We understand that the SBA has improved its efficiency in approving and processing these applications, and in fact increased the percentage of applications processed within 21 days during each of the last 4 years. I would like to commend the SBA for really upgrading the process and making it more efficient and effective. We want to thank the SBA for that as well.

Again, I appreciate your presence here today and your thoughtfulness that you give to the recommendations that you will be advancing. Obviously, your full statements and comments will be put in the record in their totality. So let us begin with the 504 program, and anything else, particularly since I am not going to be here for the entire duration, so please feel free to give me your comments on those issues that you consider to be a priority.

Mr. CRAWFORD. Good morning, Senator. I am Chris Crawford. I am Executive Director of NADCO, the 504 Trade Association. I would like to make just a couple of points, if I might, about the program.

First of all, we do appreciate your support through the years and the Committee's support. Secondly, the most important thing to us is that our program must be reauthorized by September 30th. We are unlike other SBA programs in that we receive no appropriations. So if we are not part of an appropriations bill, on September 30th we are dead ducks if we are not reauthorized. So that is crucial to us. I would also say that our core mission, as you probably know, is job creation. You cited the numbers over the past 3 years. I believe SBA's numbers over the life of the program are in excess of 1 million jobs created, which is a pretty impressive record. Our loan volume for this year is up 22 percent, year-to-date, over last year. Last year we were up 15 percent, and we continue to grow. As the banks contract and pull in their credit horns, there is a further demand for this program and it is crucial.

I would say that we have traditionally been part of the 3-year reauthorization. I believe the Administration is proposing a 6-year reauthorization. We are opposed to that. We believe that is too long of a time to go between Committees looking at the program. Business lending is a dynamic process, a dynamic program. However, business needs change. The only way we can change the program year to year is through the reauthorization process.

We have provided the Committee with a substantial legislative package. We are working with your staff and Senator Kerry's staff on that package. We hope you will seriously entertain it and work

with us on that. We have also talked to the Administration about it. I think we have had very productive discussions with the Administration.

OMB, I cannot help but bring up the subsidy model. Once again, we are concerned about the fees of the program. We have talked for the last 6 years now about the inaccuracies of the subsidy model. We continue to be concerned about that. We would like to see it continue to be looked at. We would like to continue to work with the Administration on the subsidy model to see that it is revised and made more accurate. We have concerns about, frankly, the recovery rate on the program. The subsidy forecast for this coming year is a 17-percent recovery rate. That is extremely low. We believe that there are better ways to work with recoveries on our defaulted loans and, again, we would like to work with the Administration on that.

Finally, I would comment on, and you touched on it, the centralization pilot, the processing pilot. This pilot has been in effect, I believe, for only 2 months. At this point its track record, in my view, is nothing short of phenomenal. They have reduced the processing time for 504 loans for small businesses from anywhere from 2 weeks to 30 days to 40 days down to 2 to 3 days, which is amazing. Frankly, we predicted it. So it is coming true. We want to encourage the Administration to continue to move more district offices into this pilot as its success continues, and we are very supportive of it.

Finally, I believe that Sally will talk about some things such as streamlining and centralization.

[The prepared statement of Mr. Crawford follows:]

National Association of Development Companies

NADCO

**STATEMENT**

by

**The National Association of Development Companies**

on

**The Small Business Administration**

# 504 Loan Guaranty Program

# <u>Proposed 504 Reauthorization</u>
# &
# <u>Industry Legislative Request</u>

Submitted to the

**COMMITTEE ON SMALL BUSINESS**
**& ENTREPRENEURSHIP**

**UNITED STATES SENATE**

by

**Mr. Christopher L. Crawford**
Executive Director
McLean, Virginia

May 1, 2003

The National Association of Development Companies (NADCO) is pleased to provide a statement to the Senate Committee on Small Business & Entrepreneurship concerning the SBA 504 program reauthorization for FY 2004 through FY 2006, as well as a review of several program enhancements we ask the Committee to consider this year. NADCO is the trade association for SBA 504 Certified Development Companies (CDCs). We represent 250 CDCs and more than 175 affiliate members, who together provided 99% of all SBA 504 financing to small businesses during 2002. NADCO's mission is to serve as the key advocate for the 504 program, and to provide program technical support, marketing assistance, strategic planning, and professional education to our membership.

504's objective is to promote community economic development through job creation and business expansion by providing long term capital funding to successful, growing small businesses. No other Federal economic development program can claim to have created over 1,100,000 jobs, as the 504 program has done. Additionally, 504 was responsible for creating and retaining over 125,000 needed jobs this past year, and we expect to create over 150,000 during 2003. The mission of the 504 program is more important today than ever before, with the economy stuck in neutral at best, and moving back into recession at worst. 504 is a critical economic stimulus program designed to enable growing small businesses invest in their communities.

NADCO would like to thank Chairman Snowe, Ranking Member Kerry, and the entire Committee, for continued support of the 504 program. Your Committee has worked closely with the Congressional leadership, SBA, and our industry to ensure the availability of capital to small businesses through the 504 program.

We have three objectives in providing this testimony to the Committee. First, NADCO will comment on the need for the Congressional re-authorization of 504. This includes the Administration's 504 authorization level, as well as the proposed borrower fees and subsidy model assumptions by SBA. Passage of our re-authorization bill by Congress before September 30, 2003 is required for the program's continued existence.

Second, we will comment on a package of legislative proposals we are submitting to the Committee for your consideration. These program modifications will enhance the program's impact on small businesses, and substantially expand access to long term capital, a major priority the Administration has set for in 2004.

Third, we would like to comment on recent pilot efforts the SBA has undertaken that substantially impact the 504 loan program.

## PROPOSED 504 PROGRAM RE-AUTHORIZATION

### 1. 504 PROGRAM AUTHORIZATION LEVEL

First, we must state that the 504 program must be reauthorized by the Congress before the end of FY 2003. Further, all of our user fees must also be reauthorized at the same time. As our program receives no Congressional appropriations, we are not covered by the legislation that provides annual appropriations to operate the SBA and its many funded programs. Thus, should no reauthorizing bill be passed and signed into law by September 30, 2003, our program will cease to exist. We urge Congress

to pass legislation required to maintain the loan and fee authorities that SBA must have to continue the 504 program.

SBA has proposed that the authorization level for the 504 program be set for FY 2004 at $5 billion. Further, the Administration proposes that the program be authorized for the next six fiscal years at that same level: $5.0 billion. We have concerns regarding the Administration's proposals. First, we disagree with setting the authorization for the SBA loan programs for the next six years in this year's legislation. Should this occur, we believe that the result could be stagnation of the 504 and those other programs over the next six years. Historically, the process of program reauthorization has provided Congress, the Administration, and our industry with opportunities to make evolutionary enhancements to the 504 program that respond to current economic conditions and the evolving needs of our small business borrowers. With the potential of no reauthorization for the next six years, we fear that there would be few, if any, such opportunities to legislate additional enhancements to 504. NADCO believes that small business in America is dynamic, and that its long term capital needs reflect this need for change as businesses grow. A stagnating program that receives little or infrequent oversight cannot be responsive to small business. We urge the Committee to maintain a shorter reauthorization cycle for 504.

Second, we disagree with fixing the loan authority of 504 at $5 billion for the next six years. The program utilized $2.5 billion in FY 2002, and we see loan demand so far in FY 2003 being well ahead of that rate. We expect to utilize between $3 billion and $3.5 billion this year.

Provided herein is an ambitious and aggressive series of changes to 504 that are designed to respond to today's urgent credit needs by small businesses. Further, several of our proposals deal with program eligibility qualifications that that will make more growing small businesses able to access the program. The leadership of SBA's Office of Capital Access has urged us through its recent Advanced Notice of Proposed Rulemaking to "think outside the box" to grow the program. Both SBA and our industry agree that many thousands of very successful small businesses are in desperate need of additional capital to maintain their growth. We have responded to SBA's challenge to our industry by presenting this Committee with a plan for growth for small business. We believe that our ideas – and small business growth – will be stymied if the 504 loan authority is restricted to only $5 billion per year for the next six years. Therefore, we urge continued growth in program loan authorization levels by Congress.

We recommend the following:

- **$5.0 billion for FY 2004**
- **$5.25 billion for FY 2005**
- **$5.5 billion for FY 2006**

As the program continues to fund itself through borrower, CDC, and first mortgage lender fees, there is no cost to the Federal government, nor any Congressional appropriation. With program growth up, we are concerned that, should banks continue their tight credit standards for small businesses, 504 demand may grow at an even greater rate than anticipated today. Further, if the Committee accepts our program changes, we believe demand for 504 will continue to increase as more small businesses are able to access this program.

The benefits to the country are numerous. New 504 projects provide new jobs in their communities by expanding the plants, equipment, buildings, and employment levels for our borrowers. In turn, this expansion leads directly to new tax bases, including:

- City & County real estate taxes from new construction projects
- State & local sales taxes from increased business revenues
- Federal & State income taxes from new and expanding businesses
- Federal & State payroll taxes from new employees.

It is clear that businesses assisted by this no-cost program are contributing to the tax revenues received by all levels of local, State, and Federal governments. We encourage this Committee to support our proposed authorization levels during this economic downturn when every job we create is putting an American back to work.

**2. 504 PROGRAM USER FEES**

Effective with fiscal year 1997, legislation imposed user fees in amounts sufficient to reduce the subsidy rate or cost of the CDC Program to zero. The necessity for annual appropriations to support the program was eliminated. These fees are derived as follows:

a) lender fee. The first mortgage lender pays a one-time upfront fee of 0.5 percent of the amount of the first mortgage;

b) CDC fee: the CDC pays an annual fee of 0.125 percent (or 1/8 of 1%) of the outstanding amount of the debenture; and

c) borrower fees: the borrower pays miscellaneous minor fees to cover matters such as the initial administrative cost of issuing the debenture and an annual fee to cover the cost of a central servicing agent. In addition, the borrower pays an annual fee based on the outstanding amount of the debenture. The exact amount of this fee is determined by SBA in order to maintain a zero subsidy rate for the program. It has ranged from a high of 0.875 percent in 1997 to a low of 0.410 percent in 2002. The fee for 2004 is 0.393 percent, based on OMB and SBA subsidy model projections.

All of the above fees are sunset October 1, 2003. Without this reauthorization of fees, the 504 program will cease operations on September 30, 2003.

**NADCO requests that this sunset be extended for three additional years until October 1, 2006 in order to provide for continuation of the 504 program even absent appropriated funds.**

**3. 504 BORROWER FEE DECREASE**

SBA's proposed FY 2004 budget decreases the annual fee charged each 504 small business borrower from 0.425% to 0.393%.

While several factors influence the program cost model, I would like to focus on only one: the program's recovery rate on defaulted loans.

SBA's forecast of their recoveries on defaulted loan collateral again declines – to an abysmal 17% from last year's 20% forecast. We do not understand this forecast, given the clear results of two

on-going SBA programs. One program, the Congressionally-mandated 504 liquidation program, has had very positive results. With virtually all loans accounted for, the average recovery rate for both CDC and SBA staffed efforts has easily exceeded 45% of the outstanding 504 loan balance.

Additionally, three years ago, Congress mandated that this pilot liquidation program be made permanent and expanded (P. L. 106-554). It had clearly demonstrated that the liquidation staffs of CDCs could recover effectively as much or more outstanding project amounts as SBA staff had historically done. Given the declining SBA budget and staff size, our industry felt then, and continues to believe, that more resources must be brought to bear on collection of defaulted loans.

The other program, the SBA asset sale program, has resulted in sale of about 1,000 504 loans for over $200 million. Again, we have been told for some time that the recovery rate for the asset sales program has exceeded 45%. Even the Administration's own budget last year noted that **"the Agency implemented a highly successful asset sale program and will continue to strategically sell our loan portfolio."** If a 17% net recovery is the definition of highly successful, SBA should seriously consider allowing more private lenders and CDCs to perform the recovery process. Neither the Administration nor this Committee should accept this low recovery rate as the norm.

**NADCO requests that Congress reinforce to the Administration the need to fully implement the legislative intent of P. L. 106-554 by immediately issuing regulations.**

## PROPOSED 504 PROGRAM ENHANCEMENTS

### 1. PCLP LOAN LOSS RESERVE

In 1994, Public Law 103-403 established the Premier Certified Lenders Program on a pilot basis as section 508 of the Small Business Investment Act of 1958.

Under this program, proficient CDCs could receive delegated authority to approve debentures on behalf of the Agency (and to foreclose defaulted ones) providing the CDC agreed to reimburse SBA for 10 percent of any loss sustained by it on debentures approved by the CDC under the pilot program. The benefit to the CDC would be much faster loan approval and for the Agency, it would stretch limited resources. The program was deemed a success and in 2000 it became a permanent program pursuant to Public Law 106-554.

In order to assure that there would be funds available from which the CDC would reimburse SBA for losses, the CDC is required to establish a loss reserve fund in an amount equal to 10 percent of the CDC's exposure to SBA under the PCLP program.

Some CDCs, particularly those who entered the pilot program, are processing a large volume of their debentures through the PCLP program, and loss reserves of several companies are at the $1 million level and growing, while others are approaching this same magnitude.

#### (a) Basic Reserve

When the PCLP program was established, the statute did not recognize that the amount of SBA's risk of loss decreases as the debenture ages. Debentures are issued for either a ten or twenty

year term and are amortized, i.e., the borrower repays part of the financing every month just as most home owners do on their mortgage, but the amount of the CDC's loss reserve or security never decreases until the debenture is fully paid off. Thus as the principal on the debenture decreases each year and the amount of the reserve remains constant, the reserve percentage actually increases.

For example, a 20 year debenture for $414,000 with an interest rate of approximately 4.8 percent would require a CDC to contribute $4,140 to the loss reserve.

By the end of year 5, the principal would be reduced to approximately $344,000, but the loss reserve which was originally 1 percent would be 1.2 percent.

By the end of year 10, the principal would be reduced to approximately $255,000, but the original loss reserve of 1 percent would have increased to 1.6%.

By the end of year 15, the principal would be reduced to approximately $143,000, but the loss reserve of $4,140, which was originally 1 percent, would have increased to 2.9 percent.

And it continues to grow so that by the end of year 19, a reserve of 1 percent has increased to more than 14 percent.

In other words, after 19 years the CDC is maintaining a reserve of $4,140 to assure that it will pay 10 percent of any loss and yet the principal has been paid down to $29,000 and the CDC's share would be only $2,900 or less than the amount in reserve.

Finally, however, the debenture will be completely paid, and then and only then is the CDC permitted to withdraw from the reserve the entire $4,140.

It appears much more logical to amortize the amount of the loan loss reserve the same as the debenture amortizes, thereby reducing the amount of the required reserve as the borrower re-pays the indebtedness.

**NADCO requests that the mandatory reserve be reduced annually as the debenture is repaid and the CDC be permitted to withdraw a proportionate amount of the reserve but maintaining the minimum amount of the reserve throughout the life of the debenture at the initial requirement of 1 percent.**

**(b) Alternative Loan Loss Reserve**

When Congress was considering establishing the PCLP program, there was concern that the CDC (to whom SBA would delegate decision making authority) should have a financial stake in approving the loan and not simply act as a rubber approval stamp with SBA bearing all the liability. Thus the CDC was required to agree to assume 10 percent loss exposure and to establish a loss reserve of 10 percent of this exposure.

Although some 25-30 CDCs have elected to seek designation as Premier Certified Lenders, many have not done so due to the required assumption of risk and the excessive amount of the mandatory loan loss reserve. Some have voiced the opinion that the amount of the reserve is completely arbitrary and is not based upon any loss study.

Other industries, such as the banking industry, have already moved from a "loan-by-loan" reserve to a "pool" reserve to cover their exposure to loss.

Obviously the goal would be to establish a more accurate computation of the necessary reserve which would be based upon the actual loss experience of each individual CDC. The reserve would be established in an amount sufficient to protect the Government and the taxpayers from risk of loss due to default, but the amount would not be excessive and would free funds which the CDC could use to help provide additional assistance to small business.

Due to the complexity of establishing a loss reserve for each CDC, there would be cost involved to the CDC. Not all CDCs would elect to conduct the necessary study and they should not be required to do so. Instead, they would continue to fund a 1 percent loss reserve without regard to their actual loss experience, but it would be in proportion to the amount of the debenture remaining unpaid as is discussed above.

Other CDCs, however, especially those with higher loan volume, might elect to do a loss study, anticipating that it would show that an adequate loss reserve would be in a lower amount based on that CDC's actual loss experience. We believe this option should be provided.

**NADCO requests that CDCs who elect to participate in the PCLP program be allowed to establish a risk-based reserve to protect the Government against loss as an alternative to the 1 percent loss reserve requirement. This alternative would be available to a CDC only if (1) the CDC voluntarily elects to participate, (2) the CDC has experience as a PCLP participant and has a loan loss reserve of at least $25,000, (3) the CDC contributes such additional amounts as are determined necessary by a third-party auditor employed by the company to protect the Federal Government from the risk of loss associated with the portfolio of PCLP loans of the company and (4) the SBA determines that the CDC has established a process for analyzing the risk of loss associated with its portfolio of PCLP loans and for grading each PCLP loan made by the company on the basis of the risk of loss associated with such loan.**

### (c) Reserve Account Investments

The authorizing legislation for the loan loss reserve also restricts investment of the funds. The CDC is given a choice of either placing the funds in a Federally insured depository institution or obtaining an irrevocable letter of credit.

In the early years of the pilot program, these restrictions on investments did not present much of a problem. Recent increased use of the program, however demonstrates that CDC loss reserves can build to very large balances and can easily exceed the current Federal deposit insurance limit of $100,000. This has required CDCs to open more and more local bank accounts to protect their deposits through the FDIC insurance.

Given the sophistication of many CDCs and the U.S. financial markets, it appears that there are good and safe alternatives to limiting deposits solely to accounts directly in insured institutions. For example, funds could be deposited with a securities broker, who would invest them in government bonds, or in bond funds that invest exclusively in appropriate Federal, State, or municipal debt instruments.

**NADCO requests that CDCs be authorized to invest their loan loss reserve funds, either directly or through a broker, in Federal debt, securities issued by Government Sponsored Enterprises, mutual funds which are limited to investments in money market securities consisting of Government securities and commercial paper rated not below the top tier and investment grade corporate bonds.**

**2. DEBENTURE SIZE**

Existing law imposes a maximum debenture guarantee of $1 million for a 504 project, unless it is one of the nine statutorily enumerated public policy goals that may include a guarantee of up to $1.3 million. Since the debenture generally is for 40 percent of the cost of the project, a 504 project generally will not exceed $2.5 million unless it is a public policy project that generally will not exceed $3.25 million.

504 is an economic development program, and each CDC is required by statute to achieve a job creation or retention ratio, either on each project or in some cases only on its overall portfolio. SBA has set the amount of debenture eligibility at $35,000 per job.

Particularly in today's economic times, it is clear that access to capital for growing small businesses has become a major concern. Without capital, even successful firms cannot grow and will not bring new jobs to their communities. Long term, reasonably priced capital is essential to fund expansion and job creation - - - the core of the 504 program. Moreover, the businesses that create the most new jobs are those that have grown beyond simply needing daily working capital to pay bills, salaries and cost of goods. These growing businesses need larger plants, more equipment, and more stability in their occupancy costs. Their increased need for larger plants and more fixed assets leads to a new and higher level of job creation. Additionally, these jobs created by successful, growing businesses are frequently better paying and provide improved employee benefits.

This economic need is particularly acute for manufacturers that oftentimes are the lifeblood of our small cities and towns. Unless these job providers are afforded sufficient capital to modernize and expand, they will wither and die and with their demise, many small towns will also cease to exist.

The current business size standard for SBA access includes those firms that have an annual net income not to exceed $2.5 million and a net worth of up to $7 million, but this is an alternative to the regular size standard for manufacturers that is generally 500 employees (and more in certain specified industries).

While SBA seeks to serve such "mid-size" small businesses, the current debenture limits on 504 do not enable the program to reach these small businesses. They frequently need plant expansions that cost up to $5 - 10 million, but have great difficulty obtaining such credit on a long tem basis from traditional lenders. Clearly, there is an unmet demand for plant expansion capital from this size of small businesses that is effectively precluded from using the 504 program due to the limit on debenture size.

For example, a North Carolina building products distribution company with 50 employees needs a new site for warehousing and distribution. This project would cost approximately $1 million and would increase employment by 10-12 individuals. The company could seek private financing, but the conventional down payment would eliminate too much working capital and would constrain

growth. The company is not eligible for 504 funding, as it already has outstanding debentures on other projects and is thus ineligible for another debenture of this size.

Another North Carolina manufacturer has an existing plant with 50 employees and needs a new $10 million plant which would add 25 and perhaps more employees. Although this example would exceed the proposed debenture limit, it is possible it could be re-structured if the disparity between need and statutory limits were not so great.

Another example is a Massachusetts silver refinery that was seeking $7 million to finance an employee buyout of a division of a big business that was in financial difficulty.

There are other numerous situations where a small business has already obtained the maximum amount of financing under the 504 program. A California aquarium manufacturer who needs additional expansion funds, a small business that owns two existing gas station/convenience stores but cannot acquire a third, and a restaurant with four locations that wants to grow and add additional locations.

Of particular concern are those businesses Congress has recognized as being so important as to be designated a public policy goal, such as minority or woman owned. Such firms clearly have had even greater difficulty in raising long term growth capital and thus Congress has provided a higher debenture guarantee. These firms also are constrained even by the higher maximum.

For example, a provider of air radar systems that detect clear air turbulence/wind shear could expand and employ another 60 or more employees. The firm already has a maximum $1.3 million in debentures and thus is ineligible for additional debenture guarantees. If additional expansion monies were available, the firm estimates that it would be able to add approximately 60 new positions with Phd or masters' qualifications.

Commercial real estate and construction costs continue to increase as our economy expands. Land, materials, and labor costs have all increased as new businesses are established and existing firms seek more or larger locations. Additionally, the costs of constructing a typical office, manufacturing plant, or retail building have grown with the advent of new technologies and increased zoning or safety needs. For example, twenty years ago, no facility would have had the sophisticated computer and communications technologies installed that today are viewed as normal construction needs. While 504 doesn't pay for the specific technologies, the capital costs of new electrical, plumbing, heating, cooling, and dedicated floor space are all absorbed by the construction financing. Additionally, government-mandated infrastructure, zoning minimums, and safety requirements have all advanced substantially as local building codes evolved and government sought to improve protection for citizens and employees. All of these changes have added costs to every commercial construction project.

**NADCO requests that the maximum size of a 504 debenture be increased to $2 million under the general program, that the maximum size of a debenture directed towards a public policy goal be increased to $2.5 million, and that a new debenture limit of $4 million be authorized for manufacturers.**

**3. JOB CREATION OR RETENTION**

As was noted at the outset, to be eligible for funding each individual project must meet a specified job creation or retention test, unless it is directed towards either improving the economy of

the locality or the achievement of one or more of nine public policy goals, in which case it is sufficient if the overall portfolio of the CDC provides the requisite jobs benefits.

The statute does not prescribe the test, but has left it to SBA's discretion. Originally, SBA regulation required one job per $15,000 in debenture guarantees. This was increased to $35,000 in 1990 and it has remained unchanged for over the past thirteen years.

During the interim, increases in the Consumer Price Index make $35,000 in 1990 equate with approximately $50,000 today.

The cost of manufacturing equipment has increased even more, particularly for computer related manufacturers.

**NADCO requests that a project be deemed to satisfy the job creation or retention requirements if it creates or retains one job opportunity for every $50,000 guaranteed by the Administration. Further, NADCO recommends that the same amount be required for the CDC's portfolio average, except that a CDC be permitted to have a portfolio average of $75,000 in higher cost geographic or targeted areas (such as Alaska, Hawaii, State-designated urban or rural jobs and enterprise zones, empowerment zones and enterprise communities and labor surplus areas).**

**NADCO further requests that a new jobs test be provided for manufacturers. We believe that this should be established at $100,000 in financing eligibility for each job created or retained.**

**Finally, NADCO requests that both amounts should be adjusted annually to reflect changes in the Consumer Price Index.**

**4. RURAL DEVELOPMENT**

The definition of "rural" has two important ramifications for CDCs and the 504 program. First, a project which is directed towards one of nine public policy goals is authorized higher maximum debenture funding ($1.3 million instead of the $1 million allowed for regular debentures) and individual rural projects need not meet the individual jobs test as long as the CDC's outstanding portfolio meets the test. Second, a CDC which is in a rural area may contract with another CDC to provide the requisite full-time professional staff and professional management ability rather than being required to have these qualifications in-house.

SBA historically has utilized the definition of rural utilized by the Department of Agriculture which was population of under 20,000. This definition was updated, however, by the 2002 Farm Bill.

Section 6020 of the Farm Security and Rural Investment Act of 2002 (P.L. 107-171) inserted a new definition of "rural" and "rural area" into Section 343(a) of the Consolidated Farm and Rural Development Act (7 U.S.C. 1991(a)): a population of 50,000 or less.

We believe that SBA should continue to parallel the Department of Agriculture in defining the areas which are deemed to be "rural" for the 504 loan program.

**NADCO requests that the CDC program utilize the Department of Agriculture's definition of "rural", namely any area other than a city or town that has a population of greater than 50,000 inhabitants and other than the urbanized area contiguous and adjacent to such city or town.**

## 5. STOCK PURCHASES

Under existing law, the 504 program may be used to finance the construction of a new plant or it may be used to acquire an existing plant. SBA strictly construes the term "plant acquisition" to mean fixed assets only; the Agency does not permit the program to finance either inventories or goodwill if the borrower is acquiring an operating business. But, under current tax law, businesses must carry their buildings, land, and large fixed assets at cost (for land) or at depreciated value for buildings and other assets. Frequently, the actual value of seller assets has grown far beyond the cost or book value.

In addition, a seller of a business may be reluctant to structure a purchase deal in which he sells only the assets. The seller may insist on making a "clean deal" by selling the entire business as a single on-going entity. For most acquisitions, this is accomplished through purchase of all of the privately-held company stock, with the purchaser assuming all debts and current obligations of the business. This allows the purchaser to begin operations with the complete business, and enables him to properly value acquired fixed assets at true market value.

The ineligibility of the 504 program to be used in appropriate circumstances to finance the acquisition of an existing business by the purchase of the stock in the seller company frustrates the economic development/job creation purposes of the program. It has adversely impacted the purchase of a California title and escrow company which would have created eight new jobs, a Texas textile plant whose expansion ultimately would have created at least 15 new jobs, and an Illinois bowling alley which anticipated adding 7 additional employees.

We believe that the sale of an existing business sometimes involves the purchase of more than fixed assets and that eligibility for 504 financing should recognize this business reality, providing that most of the purchase price reflects the purchase of fixed assets. This will enable 504 to continue its core mission of financing fixed assets, but allow the program to satisfy those unusual business acquisitions that occur in everyday business dealings.

**NADCO requests that the eligibility criteria for 504 financing be expanded to allow acquisition of an existing plant by the purchase of the stock in the corporation that owns the plant, as long as the valuation of the fixed assets being acquired is at least equal to 50 percent of the cost of the acquisition.**

## 6. DEBT RE-FINANCING

Under existing law, the 504 program cannot be used to re-finance any existing business debts. The first mortgage lender, however, may add to his 50 percent share of the project an additional amount to provide consolidation of existing debt on the land. Even if this occurs, the interest rate will probably be higher than the blended rate on the project (bank rate plus debenture rate) and the term will not be as long.

The ineligibility of any debt re-financing through the 504 program greatly restricts the program's use for many small businesses that are seeking expansion of existing buildings that were constructed in the last ten to twenty years at a previous stage of business growth. Experience indicates that it is very unusual for a small business to be completely debt free as it grows. Many times, this debt is associated with a building, plant, or store that it completed years ago, and continues to have some outstanding mortgage balance. Frequently, this may be at a high rate of interest and thus be restricting further business expansion and job creation.

Thus, application of the prohibition caused rejection of a project involving a mid-western motel, and resulted in projects with higher first mortgages plus additional injection of borrower funds in the case of a project involving a soccer arena and another involving a fast food franchise.

It should also be noted that the actual value of the current structures and land may have substantially appreciated. The business thus has real market value "locked up" in its assets that it cannot easily leverage for further growth. We believe that the 504 program restrictions against re-financing business debt unnecessarily inhibit the program from assisting such borrowers. These growing small businesses are not simply seeking to reduce their debt cost by re-financing an existing mortgage. They are frequently very successful and are addressing their growing markets by adding new plant and jobs. However, to accomplish such expansions, current mortgages must usually be paid off. Besides unlocking tied up capital for the business to enable expansion, use of the 504 program often means the business can stabilize its debt cost with the fixed rate twenty-year 504 mortgage. This provides increased financial strength for the business and improves its opportunity for success.

We continue to believe that the purpose of the 504 program is economic development, but we believe that this purpose can be better accomplished if there is recognition that re-financing of existing debt on fixed assets is appropriate as long as it is secondary to business expansion.

**NADCO requests that in addition to allowing the first mortgage lender to re-finance existing debt by adding to the first mortgage, a 504 project should be allowed to re-finance existing debt used to acquire fixed assets providing that the amount of the debt does not exceed the cost of the expansion and providing that the debt has been current for the past year and re-financing it as part of the project will provide better terms or rate of interest than exists on the current debt.**

**7. COMBINATION LOANS**

In previous times, both 504 financings and 7(a) loans were subsidized by appropriated funds to pay losses. It was thus appropriate to restrict small businesses to a choice between the two programs. This mandated choice, however, has caused problems for larger small businesses that need funds from both programs but are limited to a combined amount not to exceed $1 million under 504, or $1.3 million if the borrower is filling a public policy goal, or $1 million under 7(a).

Government financial support for these programs has been substantially reduced. The 504 program became self-supporting in fiscal year 1997 and the 7(a) program currently has a subsidy rate of only 1%. It thus appears that the mandated choice of one or the other is no longer necessary and imposes unneeded restrictions on small business borrowers.

**NADCO requests that a small business borrower be allowed to receive 504 financing up to the maximum amount permitted under the statute plus 7(a) financing up to the $1 million permitted for these loans.**

## 8. SIMPLIFIED APPLICATION

The application information and paperwork required from small businesses that apply for a 504 loan has been steadily growing. This is unfortunately true of other loan guaranty programs as well.

Congress addressed it in the 7(a) loan program more than a decade ago and SBA responded by establishing a LowDoc or low documentation loan program for smaller loans, originally $100,000 or less but now up to $150,000.

Last year Congress also addressed the problem for the B & I Program of the Department of Agriculture. Section 6019 of the 2002 Farm Bill (P.L. 107-171) directed the Department to provide to lenders "a short, simplified application form for guarantees" of $400,000 or less.

Our experience has shown that many 504 loan applications have so much financial and business material in them that the loan "packages" are actually delivered to SBA District Offices in fairly large boxes. We believe that much of the data contained in a loan package is of little or no value to Agency personnel that review and approve a new 504 loan. Most of the business financial, historical, and general business history information is gathered and closely reviewed by both the bank issuing the first mortgage and the CDC that issues the 504 second mortgage.

Given the extreme pressure that most SBA loan officers are under, and with shrinking Federal budgets and staffs, it is clear that SBA must continue to reduce the time spent on loan approvals. This will enable SBA personnel to spend more time on outreach to small businesses, as well as closer supervision and oversight of lenders such as CDCs and banks. This can best be accomplished by providing only the optimal amount of business data needed to approve a smaller 504 loan.

**NADCO requests that SBA be required, within 180 days, to develop and make available to CDCs a short, concise, simplified application form for loan guarantees of $250,000 or less.**

## 9. DEBENTURE PREPAYMENT EXPENSES

Debentures under the 504 program include a prepayment penalty if the borrower voluntarily prepays the debenture. There have been several occasions when SBA prepaid a debenture because Agency personnel erred. For example, issuing a 10-year debenture when the borrower was approved for a 20-year debenture.

Under existing law, administrative expenses in connection with issuance of a debenture are paid from program fees. We believe that any prepayment penalty triggered by SBA prepayment due to errors or omissions by Agency personnel should be treated as such an administrative expense and paid from the program fees.

**NADCO requests that any premium payment due on a debenture prepaid by SBA on account of an error or omission by its personnel to be an administrative expense and be paid from program fees as are other administrative expenses involved in issuing the debenture.**

## ENHANCEMENTS FOR MANUFACTURERS

NADCO believes that a return to a growing economy must include a revitalization of America's core manufacturing industries. Given the connectivity of international markets, our small manufacturers must achieve extraordinary new levels of productivity to compete on both price and quality. Doing this requires additional capital expenditures for plant and equipment.

The National Association of Manufacturers, one of America's largest and most respected trade groups for the manufacturing industries, completed an extensive survey and research last year into the issue of credit rationing by lenders. They concluded:

- Even with record low interest rates, 43% of small manufacturers stated their overall cost of borrowing had INCREASED, due to lender fees and interest charges
- Restrictive lending has directly affected capital spending and new hiring for 37%.

Given the record low interest rates, and favorable downpayment and loan terms offered by the 504 program, we can have a substantial impact on the availability of expansion capital required by small to medium manufacturers who are expanding their markets, products, and most importantly, their employment levels.

Our request to the Committee is to provide an extraordinary series of changes to immediately address the capital needs of small manufacturers. As listed above, these include:

- Rural definition to assist rural manufacturers that have no supportive banks
- Debt refinancing to enable them to immediately lower their borrowing costs
- Combination with 7(a) to allow greater financing for both plant and inventory
- Special limit of $4 million to reach more capital-starved manufacturers
- Special job ratio of one job per $100,000 to address the high cost of new machinery.

For the most part, manufacturers would be identified as those industries classified as sectors 31-33 of the North American Industrial Classification System or NAICS, which SBA has utilized for purposes of determining a firm's eligibility as a small business.

Not all "manufacturers", however, are in these categories. New technologies have resulted in the establishment of new manufacturers such as the producers of records, tapes, and videos. The NAICS places them not in the manufacturing sectors, but in sector 51: information.

We believe that these new age producers are manufacturers and should be afforded access to those new provisions designed to assist traditional manufacturers.

**NADCO requests that expanded debenture eligibility and higher job creation criteria be applied to both traditional and new style manufacturers by defining the term in three ways with reference to NAICS:**

**first, those manufacturers enumerated in sectors 31-33,**

**second, those manufacturers of sound and video recordings under subsector 511, and**

**third such other industries classified elsewhere as the SBA may deem appropriate.**

**11. REGULATIONS**

In order to fully implement new legislation, SBA must frequently issue regulations in order to provide for good program management and guidance to participants. Sometimes the press of other business causes a delay in formulation and publication of the necessary regulations. For example, Public Law 106-554 (December 21, 2000) made the Premier Certified Lenders Program permanent, thereby triggering the necessity of regulations. More than two years have now elapsed and regulations have yet to be proposed.

We believe that it would be appropriate for the Congress to stress the importance of issuance of timely regulations by providing deadlines, while at the same time allowing the customary 60 days for public comment on proposed regulations.

**NADCO requests that SBA be required to publish proposed regulations implementing the bill within 180 of the date of enactment and to issue final regulations within an additional 120 days.**

## SBA 504 PROGRAM PILOTS

**CENTRALIZED LOAN PROCESSING:**

SBA has undertaken an ambitious pilot that will impact every one of the six thousand 504 loans that our industry provides to small business every year. This pilot – to attempt to centralize loan processing and approval – has now been in operation for almost two months, and has about 35 CDCs from four States participating in it.

The goal of this pilot is to respond to at least two significant challenges that SBA faces for the long term:

1. <u>Rapidly growing loan programs and no-growth staff size</u>: SBA continues to focus on doing more with less, using that old adage of "work smarter, not harder." With 504 growing at over 20% per year, there is simply not enough processing capability within the field offices to meet this loan demand. SBA must identify ways to do this or risk alienating its core customers: America's small businesses.
2. <u>70 field offices that have 70 different ways of loan underwriting</u>: For years, SBA has published regulations and SOPs that are measured in thousands of pages. Yet, even these cannot force every SBA loan officer to underwrite a loan in exactly the same way their counterparts do it. One loan approved in one District may be denied in a second. Processing loans in as few as two large centralized centers will result in less inconsistency of SBA loan approvals, thereby removing a major frustration of small businesses.

SBA has proven through its successful centralized loan servicing centers in Little Rock and Fresno that a small, highly productive and trained staff can accomplish much in meeting the servicing needs of thousands of borrowers across the country. Further, the PLP and Low Doc processing centers

have already demonstrated that loan processing can indeed be centralized with a result of improved staff productivity. We see the same opportunity for success with this current 504 pilot.

Our industry supports the goals of this pilot, in light of the personnel and operating problems that SBA management is facing. We urge SBA to continue this pilot and evaluate its results quickly, in order to meet the lending demands now being placed on our industry by small businesses across the country. Unless something such as this is accomplished, loan approval delays will continue to grow.

**CDC LIQUIDATION PROGRAM:**

This "pilot" authorized by Congress several years ago to test the ability of trained staff of many Certified Development Companies to perform their own liquidations and recoveries on defaulted 504 loans was declared a success at least three years ago. Its recoveries averaged over 50% of the outstanding loan balances of those defaulted loans during the three years of the pilot. Congress mandated that the pilot be converted to an operating program within SBA, as at that time, the "recovery rate" of 504 loans liquidated by SBA staff was only about 30%.

For the FY 2004 subsidy model, the projected recovery rate by SBA is now down to only 17%. Presumably this is due to most 504 loans now being sold through the formerly touted asset sales. SBA has never responded to Congress or our industry to expand and make permanent the process of qualified CDCs liquidating their own loan defaults. SBA has never issued operating regulations as required by enabling legislation.

We urge SBA to work with our industry and this Committee to finally complete the process begun almost eight years ago: enable CDCs to recover taxpayer-guaranteed loans by going after defaulted borrowers or loan guarantors. The success of the pilot is undisputed by SBA management. NADCO believes we can work to turn around this dismal net recovery rate projected by OMB. We ask Congress to direct SBA to meet the requirements of previous legislation.

## SUMMARY

Our industry has proposed an extraordinary series of 504 program enhancements for this year. Today's economic conditions demand such measures to keep small businesses growing and creating new jobs. We believe that these changes are badly needed to expand access to long term, reasonably priced capital for more small businesses.

Nowhere is this more evident than in America's manufacturing industries. Many are unable to obtain new capital at any cost, having been shut out of their traditional banking sources. Other manufacturers are struggling to restructure debt by taking advantage of today's record low interest rates. They need to refinance existing debt, but banks simply won't deal with them. Still other manufacturers need new machinery and equipment to increase plant productivity and remain competitive in worldwide markets, yet they have limited cash to put down on expensive tooling.

SBA's loan guaranty programs must step up to meet these needs now. We must fill the vacuum left by conservative lenders who are focused on reducing their long term exposure. Without expansion of outreach by SBA's programs, we may find it nearly impossible to provide the capital to help American industry regain it world leadership role in manufacturing.

In short, SBA, its lending partners, and Congress must all reach farther than ever before to break this economic cycle America is stuck in. Our industry urges action now for the benefit of our borrowers, their employees and families, our Federal, State, and local governments, and for our economy.

Thank you for allowing us to provide our comments. NADCO will be pleased to work with the Committee and the Administration to improve the program and help America's small businesses lead the way to increased job creation.

Chair SNOWE. It appears with that pile that we need to.

Ms. ROBERTSON. Good morning, Chair Snowe. I am Sally Robertson with Virginia Asset Financing. We are the state-wide Certified Development Company in Virginia that delivers the 504 program. Our CDC has done over 1,000 loans for small businesses resulting in $1 billion dollars in projects, and our borrowers have created over 12,000 jobs as a result of those financings. Nationwide, I think through a variety of programs, CDCs have seen over 1 million jobs created through their efforts.

We think it is extremely important that the 504 program get reauthorized given the sluggish condition of the economy, the rising unemployment rates, and the ability of 504 to help the small business sector grow and create more jobs. Again, since it is at no cost to the taxpayer it would seem to be a fairly simple decision to reauthorize the program.

I would also like to mention that our small business owners who have benefited from the 504 program would tell you, if they were here today, that the things that make this program so important to them are the low down payment, the fixed rate, and the long term. They would not have been able to make the next step in their growth process if they had not had the 504 program to do that with.

I will also tell you that they will consistently say that the paperwork is extraordinarily burdensome in a 504 loan. I have brought with me an application package and a closing package. If you had to produce all that paper to do this loan, it is extraordinarily burdensome and there has to be a way to streamline this.

Chair SNOWE. That is one loan?

Ms. ROBERTSON. One loan. One application package, one closing package.

Chair SNOWE. That is really unbelievable.

Ms. ROBERTSON. We need to find a way to reduce the paperwork.

This is not only from the small business owner's perspective, but as we get into the centralized process it is extraordinarily difficult for SBA personnel to properly do their job when they have this pile of paperwork that they have to look at in order to properly approve or look at a loan that is being closed. We think there are a lot of ways in which this can be reduced.

The CDCs, I think, are overall very much in favor of centralized processing. As you know, in this day and age, small business owners are used to instant communication and instant information. Sellers of property are also used to that. If a small business owner cannot get a loan approval in a reasonable time he is likely to lose that property and the opportunity to grow and expand his business and create more jobs. We need to be able to give them a quick turnaround time on loan processing. Thirty days is just too long. Centralized processing, given the reduced staffing at the SBA, is critical to that. In order to make centralized processing work we have got to reduce the paperwork.

Chair SNOWE. Without question. You would think that even one pile would be too much, let alone two for one application.

Ms. ROBERTSON. I would agree. You have to admit too that this adds to the cost of the program for the small business owner.

Chair SNOWE. No question about that.

Mr. BROWN. I just wanted to make a comment that in Wisconsin we do not have enough filing space. We are also a CDC, doing the 504 program. I think we currently have about 110 loans outstanding. I would agree with Sally that the administrative part of it gets quite burdensome, so any effort to make that more streamlined would be helpful.

Chair SNOWE. Ron, do you think that is possible?

Mr. BEW. Absolutely. When I came on board a year ago, I looked at the 7(a) programs and made changes to 7(a), and now the focus is on the 504 program. Somebody deemed that, even though I am credited with it, I am not sure I did, this is the year of the 504, just to show our emphasis and focus on this program. When I was a lending officer, I did a loan, a huge loan with VEPCO which is Dominion Resources, and the documentation was that much more for a multi-million dollar loan.

Ms. ROBERTSON. This one was $300,000.

Mr. BEW. So it is a great visual of the problems in the program. We definitely will streamline this program.

Chair SNOWE. We appreciate that.

Julie.

Ms. CRIPE. I would like to make two comments. One, I concur with the reduction of the paperwork. As a lender of a $300 million community bank, of which I am the President, we do many, many 504 loans. We find it is a great program. That is my day job, and by night I was the President of a state-wide CDC in Texas, and I am now the Vice President. I stepped back after 8 years.

It is a great program but the paperwork is very burdensome to small businesses. The small businesses I deal with are very busy. They walk into the closing room and they really have a reflex that is unbelievable when they see the paperwork. It sometimes takes 4 and 5 hours to pass the documents around just for signature. So I concur with that.

I would like to make one comment about recoveries, because I believe that everything is into interrelated, and it speaks to our subsidy rate and the reason that we perhaps do not get the subsidy rate we would like to see. I think there is a lot of work that can be done on recoveries that are positive for taxpayers and lenders and CDCs. I have seen many examples, which I will not go into, of SBA making a decision not to buy out a first lien or to rush to walk away from a 504 second lien position when in fact they could recover 75 to 100 percent of the debenture amount. As a taxpayer that is distressing to me. As a lender, the bank comes out whole, no question. But wearing my CDC hat I feel that it can be worked on in some very simple ways that are not going to create a burden of administrative costs and actually can go through the CDCs for recommendations. Thank you.

Chair SNOWE. Thank you.

Chris.

Mr. CRAWFORD. Senator, we did a study, our Association did a study about 5 years ago in advance of this Committee authorizing a liquidation pilot, which Patty will certainly recall whereby about 20 CDCs actually tried to do their own liquidations as opposed to having the SBA doing the liquidations. The results were better

than 50 percent average recovery on the outstanding loan, the guaranteed loan.

We did this because we also talked to a number of SBA staff, the portfolio management staff out of the field. These are the people out in the field that actually do the recoveries. We found that some of them had loan workout, workloads in excess of 200 loans. We then surveyed commercial banks and said, how many loans do your workout people work on at one time. Twenty to 30 loans. It is just humanly not possible to work on 200 recoveries at a time, and the SBA simply is not staffed to do that, which is why we advocated to do this pilot that was, in my own view, very successful. Following that, this Committee actually got passed a bill which made that pilot permanent. We continue to await regulations on that pilot which would make the pilot available to many other qualified CDCs. We would like again to work with the SBA to get those regulations established so that we do that.

Chair SNOWE. When was this pilot established?

Mr. CRAWFORD. The bill that actually was established was Public Law 106–554 which made that pilot permanent; is that not correct, Patty?

Chair SNOWE. When was that? The last Congress? Two Congresses ago? So why have the regulations not been developed and implemented?

Mr. BEW. I do not know. I will look into that.

Chair SNOWE. 2000, the reauthorization.

Mr. CRAWFORD. So we think there is a real opportunity to help on recoveries. There is a direct impact on our fees, and we think this is the opportune time. As the agency looks to streamline its processing, streamline its other services, deals with its budget problems, we can help. Every CDC in this country is prepared to help on this. I think we have proven that we can do it.

Chair SNOWE. Absolutely. Would you follow up on that?

Mr. BEW. I will follow up on that.

Chair SNOWE. It is critical.

Mr. BEW. Our overall theme has been to push more and more of the decision making, use of forms, and processing out into the private sector. I am sure this could be a logical extension of that theme.

Chair SNOWE. The liquidation issue, it is because it does require much staffing to do it, is that what accounts for the difference between the SBA and the private sector?

Mr. CRAWFORD. It requires a lot of work.

Chair SNOWE. It requires a lot of work to drive it and to recapture the greatest amount. That is a good suggestion. Any oversight problems with that from GAO?

Ms. D'AGOSTINO. Actually we have not looked recently at the 504 program. We have not been asked to and we have not done any on our own initiative. We have mostly focused on 7(a) lender oversight and disaster lately.

Chair SNOWE. What are the most effective or ineffective aspects of the 504 programs? One is the issue of the subsidy rate and paperwork, streamlining? Anything else in the 504?

Ms. ROBERTSON. From a lender's perspective I would think that the PCL regulations which we have been hoping for for sometime

would be issued to give qualified certified development companies more authority to process loans. Additionally, the change in the job creation ratio from 1 per 35,000 to 1 per 50,000. Jobs have become far more expensive to create. It would allow us to help more businesses where the cost of those jobs are higher, such as manufacturers.

Ms. CRIPE. I am here really to speak about Senate bill 822 which applies to the 504 program. It is something that actually came up 4 years ago in my own bank when I was approached in a minority neighborhood to finance a daycare center. The woman was successful and had been running a child care center. She needed to expand her business and wanted to buy the building that she had identified would add another 100 kids to the program. She was a nonprofit. She would fully guarantee the loan, getting that issue out of the way. It was not a credit issue as her credit was strong. She paid her bills. It was not any kind of corporate welfare, if you will. She fit all the credit criteria.

She did not have a lot of cash because she was expanding so the 504 was the perfect fit for her. After much ado, we found out that she did not qualify because the company was nonprofit. We thought perhaps we could put it in her name, since she owned the company 100 percent, and she could create a for-profit company to own the real estate. That still did not fly, and in fact we met with SBA and it just did not fit within the parameters of the regulations.

So a long story short, we were not able to do it. She had to maintain the nonprofit status in order to get the parents the subsidies for their children to be allowed to be in her daycare center in this enterprise zone. It was not an option for her to give up the nonprofit status that she had in this particular daycare. I think it is very important that this pilot program be attempted in an opportunity for us—I have financed many, many daycares under no program whatsoever and no defaults to date. I think that Sally can speak to that same issue. She has done even more.

Ms. ROBERTSON. We have done $28 million worth of daycare projects in Virginia for 26 small business owners. We have not had a single default under the 504 program in any daycare center transaction.

Chair SNOWE. Thank you. Ardith, do you want to speak to this?

Ms. WIEWORKA. Yes. Good morning, Chair Snowe. My name is Ardith Wieworka and I am the Commissioner of the Massachusetts Office of Child Care Services. I just wanted to talk this morning about how important the Childcare Lending Pilot Act would be to childcare providers. Certainly in Massachusetts, but I am sure across the Nation. We have about 15,00, 16,000 licensed childcare providers in Massachusetts. I know this map is a little hard to see, but basically all those little dots, those are the licensed childcare providers in Massachusetts. It is really a huge industry. These are businesses. These are businesspeople.

At the Office of Child Care Services we regulate this industry, we license it, but we also administer the subsidy system. There are 50,000 kids, low income kids, kids from unstable families, and disabled kids who use our subsidies. In this industry, many of these programs are in church basements, and historically, therre are very low margins that these programs run on. The extension of the 504

program to nonprofits would really make a huge difference in their abilities to succeed.

For the kids in those programs, we have basically a two-tiered system. There is your high-end national childcare chains. Those chains are not beating down the door to take care of poor kids. But there are a lot of dedicated, passionate nonprofit programs that do want to take care of the kids, the poor kids that we serve. This program would allow them to do things like build new classrooms.

We were having a debate earlier about whether playgrounds would qualify. I know that the playground in my elementary school is still there, so that is more than 10 years. But I think that there are a lot of adaptive measures that are needed for disabled kids. If you have a kid in a wheelchair, you need a ramp or you need certain designs of the program. The design of a program is so important. At OCCS we have prosecuted cases of child mistreatment simply because mistreatment went undetected because of the design and layout of the classroom.

There is an enormous potential for positive outcome here if these programs had access to money. That is really what it comes down to. They need the access to money to improve the program, to improve positive outcomes for disadvantaged kids. That is really the win-win here. This would support the goals of the 504 program and it would support kids. It is a winning combination.

[The prepared statement of Ms. Wieworka follows:]

Testimony Before The Senate Committee on Small Business and Entrepreneurship

Submitted by: Ardith Wieworka, Commissioner
Massachusetts Office of Child Care Services

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Madam Chair, Ranking Member Kerry and Honorable Members of the Committee.

Good morning. My name is Ardith Wieworka, and I am the Commissioner of the Massachusetts Office of Child Care Services. It is a great honor to be invited to participate at today's roundtable focused on the Small Business Administration's credit programs. My testimony today is focused on the SBA's 504 loan program and specifically Senate Bill 822, the Child Care Lending Pilot Act of 2003, which would create a three year pilot program that would make small, non-profit child care businesses eligible for SBA 504 loans.

<u>Investing In The Non-Profit Child Care Industry Is A Direct Investment In Children and Promotes the Goals of the SBA</u>

When we can benefit children and the goals of business and government all at the same time, we have the ultimate winning combination. The Child Care Lending Pilot Act does just that.

The SBA's 504 loan program furnishes growing businesses with affordable long-term, fixed rate financing for acquiring long term fixed assets. What does this mean for child care programs? It is the new preschool classroom that could be built, it is the adaptive measures needed for children with disabilities, it is the equipment that supports sound curriculum, and it is the miniature size bathroom fixtures that cost more than their adult size counterparts. We know that these are the things that make children feel safe, and provide for their physical, emotional, social and cognitive needs. And those are investments that pay back forever for a child's, and therefore all of our, future success.

The 504 loan program is exactly the type of financial assistance that is needed for child care businesses to grow and, sometimes, to survive. However, although most child care businesses meet the criteria for this 504 loan program, it is unavailable to much of the child care industry because <u>non-profit</u> corporations are currently not eligible for SBA 504 loans.

The SBA is founded on the principles that free competition and free entry into business are basic to our nation's economic well-being and security. The non-profit child care industry not only contributes to the economy as a major employer and community level investor, but it also allows parents of all income levels to

participate in the workforce while it prepares children for future academic and employment success.

I will share with you what we are experiencing in Massachusetts in the child care industry, and how the proposed pilot program in Senate Bill 822 will enable the growth of this important business sector, while also promoting the growth of the overall economy and free competition.

The Massachusetts Experience

The need for quality child care has become a fact of life for most parents in Massachusetts and across the nation. 65% of women whose children are under the age of six are participating in the work force. In Massachusetts, the child care industry contributes $1.1 billion to the economy annually, employs 44,000 people, and makes it possible for 253,000 parents to go to work.

As in most states, the demand for child care in Massachusetts exceeds the capacity, especially for low income families. We have 19,000 Massachusetts children on a wait list for subsidized child care. The lack of capacity to care for these children is not attributable to a lack of interest in the field. More people would get into the business if they had the resources. Unfortunately, the main funding streams to finance this industry specifically prohibit their use for capital projects. Both the federal child care block grant and our state's own grant program funded from sales of a children's license plate, do not allow businesses to use that money to build or renovate. Children wait for care while businesses fail to secure conventional loans from banks. At the same time, we receive numerous enthusiastic requests from dedicated child care professionals who are seeking to expand capacity in their communities. We cannot currently help, but the Child Care Lending Pilot could.

The capital needs out there are real. One non-profit child care business in Massachusetts wants to upgrade their electrical wiring because currently they can't use their computers and air conditioning at the same time without blowing out their system. They can't secure the loan to do the work. Summer is around the corner. Are these the choices we want them to make? Another program's furnace died this winter, and with no loan to replace it, the sustainability of that business was at stake. Parents aren't going to stick with a child care business that closes because there is no heat in the winter. Parents have to get to work. SBA loans can make the difference between business success and business failure.

At the Office of Child Care Services, we contract with over 275 businesses to provide subsidized quality child care to low income working families. 90% of our contractors are non-profits, many of which are women and minority owned businesses. These child care businesses operate on thin margins because reimbursement rates from states are low. The non-profits in this field do not have

great advantages by virtue of their non-profit status over their for-profit counterparts. The fact is that many for profit, high end, national child care chains are not beating down the door to serve poor children. Expanding access to SBA loans for our non-profit child care businesses will increase the quality and sustainability of programs for the Commonwealth's most vulnerable populations: poor children, children with special needs, and children from unstable families.

These children need our support to succeed. By allowing our non-profits to tap into SBA's assistance, we are investing in both business and children, while allowing thousands of additional parents to go work.

Sound Investment In the Future

Allowing non-profit child care businesses to participate in the SBA 504 loan program not only encourages the growth of the overall economy in the short term, but it provides a solid foundation for the next generations' workforce.

Current research finds that the earliest experiences of children from zero to age three have a profound effect on their future success in school and in life. Studies have demonstrated that high quality child care programs can increase school readiness, and have long term benefits of increased income, improved health, and reduced delinquency. Expanding the eligibility for SBA 504 loans to non-profit child care businesses can greatly contribute to these positive outcomes.

Non-profit child care businesses can use these loans to improve the design and layout of a child care physical environment, including interior improvements, equipment and the very important outdoor playgrounds. These are not insignificant matters or mere child's play. Research shows that children's "space" has an enormous impact on children's learning and behavior and on caregivers' ability to do their job. An effective physical environment supports children's interaction with materials and people and helps children feel invited and welcome to explore and learn. And, of course, attention to these matters keeps children safe.

At OCCS, we have investigated and prosecuted cases of child mistreatment that went undetected by classroom teachers or directors because the space for children was not appropriately designed. At the end of the day, parents have one overriding concern: is my child safe? We cannot underestimate the importance of improvements to programs that directly enhance the safety of our children.

Increasing capacity in child care programs through SBA loans will also increase parental employment benefits and general economic opportunity, especially for families moving off of welfare. Parents of young children in child care are more likely to have increased opportunities to enter the work force or move from part time to full time work, improve their ability to accept career development opportunities, and increase their financial independence. Publicly subsidized

child care decreases immediate and long term social assistance costs, reduces child poverty, and increases future access to educational opportunities, improves productivity, and increases tax revenues. To make it work though—there needs to be a place for children to go. More loans, more building will mean more places for children to go.

An investment of $1 in quality child care yields $7 in long term savings and increased revenues. This investment in the non-profit child care industry is sound. As Lord Byron wrote "ready money is Aladdin's lamp." Participation in the SBA program would make many wishes for better care and education for our children come true. I would urge that you support Senate Bill 822.

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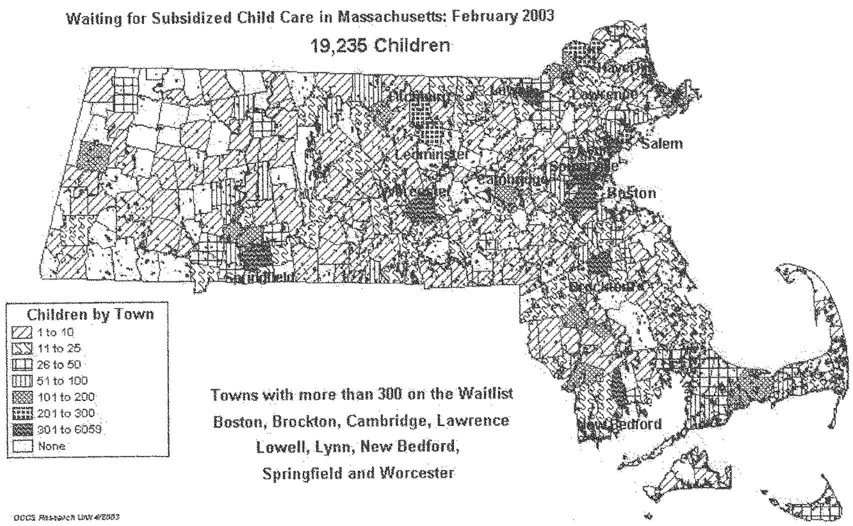
Madam Chair, this concludes my prepared testimony. I would be happy to respond to any questions you or other members of the Committee may have.

<u>Contact Information</u>
For further information, please contact:

Ardith Wieworka, Commissioner
Office of Child Care Services
1 Ashburton Place
Suite 1105
Boston MA 02108

Tel. (617) 626-2012
Fax (617) 626-2028




## Massachusetts Child Care: Providers and Capacity

| Progam | Number of Providers | Capacity |
|---|---|---|
| Family Child Care | 9,928 | 62,465 |
| Group Child Care | 2,305 | 115,338 |
| Schoolage Child Care | 930 | 45,412 |
| Residential/Placement Providers | 697 | 8,039 |

Chair SNOWE. What is the question here, Ron, about opening it up to nonprofits? I think that is one of the issues. I do not have any question about the need and availability of childcare facilities and supporting that. Certainly it is absolutely essential for so many people, in order to enable them to go to work, opening small businesses, as an adjunct to businesses. What is problematic here, if anything, with respect to opening the door to nonprofits?

Mr. BEW. I think it is statutory. The statute requires a borrower to be a profitenity, although in the Microloan program there is an exception to that. It would require a statutory change to let nonprofits into the 504 program.

Chair SNOWE. It is statutory in the sense that it prohibits or it is confined to only for-profit. But whether or not, does that present any problems?

Mr. BEW. Philosophically, I think the program was set up for for-profit entities. We would have to look into that.

Chair SNOWE. Whether it is a slippery slope?

Mr. BEW. Whether it opens the door to other nonprofits.

Chair SNOWE. It is something to certainly explore. It is an interesting issue. There is no doubt about it. The need is out there, undeniably. Obviously, that is a dimension of small business and it is a major issue in the development and helping to create more daycare facilities. We just have to explore the different dimensions, if there was a rationale for nonprofits.

Chris and Julie.

Mr. CRAWFORD. Senator, I have to agree with Ron. I do not want to characterize it as a slippery slope. Obviously our program was established to make loans to for-profit small businesses to enable them to repay their debts. Given that we have no subsidy, we have zero appropriation, and it is something that my industry is extremely sensitive to. Because the minute our losses start going up, our fees go up, the demand for our program gets less and less. So we are very concerned about that. We want to be very cautious in this. I believe that it has been proposed that it be a pilot. I think that it is most appropriate to try and see how it works.

I do not want to sit here and encourage that we look at opening this loan program to every Tom, Dick, and Harry nonprofit that is in the country. I do not think that is appropriate. Daycare is a very special circumstance.

Ms. FORBES. I would just like to say for the record, the reason that Senator Kerry was looking at opening this up to nonprofits is because in this industry such a high proportion are nonprofit, and there did not seem to be another way to get the money to this very needy cause.

Ms. CRIPE. My favorite way of debate, I guess, is to use analogies. I am in the trenches every day and my bank is located in a minority neighborhood, has been for 50 years in Houston, Texas. We have just at my small bank, 114 church accounts and over 100 of those have loans with me. They are not eligible for programs, and I am not advocating that. As Patty brought to everyone's attention, in the daycare industry I do not have a Kindercare, if you will, coming to my neighborhood to serve that area. They are not going to come. The real estate will not support what they normally want to do.

The elementary schools are understaffed and they have problems. If we can get experienced people to open daycares and expand, then it certainly meets the spirit of the 504 program, which is job creation and meeting the needs of economic development in underdeveloped areas. I have seen repeatedly the daycares fix up the neighborhoods, if you will, because if they buy a building, if they have ownership, it creates a sense of spirit in the whole neighborhood that makes a pride come about.

I understand the slippery slope that we are talking about. I understand that most of the churches in minority communities lead the charge in economic development. They form separate corporations which, yes, are nonprofit. That has to do with the fact that, and I am sure Ardith can speak to it better than I, they must have a nonprofit status in order to receive the subsidies to get the children in there.

Chair SNOWE. That is an interesting point where they develop a different entity for that purpose, because how then would you collect collateral, using collateral from a church, from a religious institution?

Ms. CRIPE. You do not. They create a separate nonprofit. We all know that nonprofit does not mean they do not make money—as a separate business. That owns the real estate. They also hire the teachers and supervise. In fact my own church does that in Houston and we are not—all churches are nonprofit.

Ms. WIEWORKA. I just wanted to point out, in Massachusetts the childcare providers that we contract with, 90 percent of them are nonprofits. They do that for a variety of reasons. It gives them certain access to other Federal programs that if they were for-profit they would not be able to access. I wanted to say, I think one of the reasons this for-profit versus nonprofit issue comes up is that nonprofits are considered—they already get a break because they are nonprofits, so we do not want to give them another advantage over for-profits. But I think that the historically low rates of reimbursement for childcare providers puts them in no significant advantage over their for-profit counterparts.

The childcare industry is also, I think, unique in that it absolutely is an industry that supports workforce development. The bottom line is, if you do not have a childcare provider and you have kids, you cannot go to work. If you do have a childcare provider, you can go to work. I think it meets the goals of the SBA program.

Chair SNOWE. Do any of these nonprofits, childcare facilities develop into schools, or become schools?

Ms. WIEWORKA. Sure.

Chair SNOWE. Does that create any complications there, in your estimation?

Ms. CRIPE. I also have the issue of charter schools in Texas and we are not allowed to use the SBA program for charter schools. Again, I have financed 10 of them in the last year and I have had no collection problems whatsoever.

One issue that I know will come up is personal guarantees. As I mentioned in my previous example, the businesswoman who was running the nonprofit daycare center was willing to step up to the plate and personally guarantee the loan. Her credit was impeccable and she was a good businessperson.

When I loan money to churches, I typically have the Deacons sign on the dotted line as guarantors. So the guarantee issue, I believe, can be resolved.

Chair SNOWE. Maybe many of these questions could be addressed through a pilot project, so that is something that we will obviously explore.

Mr. BROWN. Just one quick comment. I think, representing CI, we have done about 150 childcare loans in Maine, in excess of about $8 million. One of the issues is quality of childcare, and one is the facilities in which they provide their programs. I would see this as a way to provide that long-term lower-cost financing to make that happen.

Chair SNOWE. There is no question there is a tremendous need out there for quality, and affordable daycare without a doubt.

One other question I wanted to follow up on with the 504 and the 7(a) program, do you think they overlap between those two programs? Is there a need for two separate programs?

Mr. FOREN. Absolutely. There is a definite need. I have a view on this that other people may not share. In a prior life I had something to do with the 7(a) and 504 program. 7(a), historically is a secured lending program and so is 504. 7(a) typically has been used for working capital short-term. The 504 program is a different program in that it is strictly fixed asset financing for small business development, creating jobs. They have a distinct purpose. 7(a) is under the Small Business Act, 504 is under the Small Business Investment Act. The purpose of the Small Business Investment Act has a slightly different focus than the Small Business Act. I think there clearly is a need for the 504 program.

But if I could just take a rabbit trail, I understand you are leaving in a few minutes. We have an SBIC and we have a small business that we financed up in upstate New York that is in a decommissioned Air Force Base, kind of like Loring, and in that business we are completing an equipment line that requires new equipment of $1.5 million. Ideal for 504 financing. I found out in the last 2 to 3 weeks that I have got a problem, and that problem is simply this. Since we own more than 20 percent of the small business, not much more but a little bit more, our SBIC is required to guarantee that loan, the 504 loan, which then uses up my liquidity that I could provide to the business if it needs additional liquidity in the future.

Something needs to be done relative to giving SBICs some flexibility and not requiring personal guarantees so that these two programs can be used in concert to help small business development. I know that is not part of the subject area, but it is critical.

Chair SNOWE. It is.

Mr. FOREN. Lee has got a copy of—would you provide the Chair with the product? It is a small business.

Mr. MERCER. There is no powder in this. It is safe. But that is an SBIC investment in an LMI company.

Mr. FOREN. It would qualify as an LMI.

Mr. MERCER. It is a new way of applying polymers to ammunition which will reduce—Wayne can tell it better—reduce the weight of the ammunition by 25 percent.

Chair SNOWE. Is that right?

Mr. FOREN. It is cheaper and safer. You throw a handful of those bullets into a fire, they will not explode. The plastic will melt and the powder will fizzle. This is in the final stages of testing with the military and we hope that in the fall it will be ready for acquisition by the military. This is disruptive technology in the small arms area. To me it is a sad commentary that we cannot use the 504 and 7(a) program, or the SBIC and 504 program in concert to help complete this plant.

Chair SNOWE. Because of the high-level guarantee?

Mr. MERCER. What the guarantee does is once Wayne has to guarantee the 504 loan, that counts as a financing in the SBIC regulations and therefore he runs the risk of violating what are known as the overline limits. In other words, he would be considered to have invested, because of the guarantee, too much in one company.

Mr. FOREN. I can only put $3 million into any one deal. We have already invested $2.5 million. The 504 portion of this loan is close to $600,000. If I were to guarantee the loan I would be in violation of SBIC regulations. The only way around that is to get SBA to approve an overline request. But if I do that I have used up my precious dry powder, as it were—no pun intended—to be able to give this company further assistance. So I will talk with the folks at the SBA and see if we cannot get an exception, but heretofore have not been able to do that.

Chair SNOWE. Ron, do you have any response to that?

Mr. BEW. We can look into it. It is the first I have heard of it.

Mr. FOREN. It is an SOP issue. It is not regulatory, and it is not statutory.

Mr. BROWN. We have actually run into a similar type of dilemma using the 504 with our venture capital funds. Because CI is the sole owner of our for-profit venture capital funds, including our New Markets Venture Capital fund, we are restricted from using the 504 program with our equity positions in the companies that we are investing in. It would be nice to be able to combine the two.

Mr. FOREN. This would apply for 7(a) as well as 504.

Chair SNOWE. We will look into that.

Ms. CRIPE. I was going to go back to your original question and state that, yes, I believe the 504 and the SBA 7(a) are two distinct programs and are not needing to be combined. They meet different needs for the small businessperson. When a customer approaches me for a loan, I try to find what will best fit their business. For most of them in expansion, and the 504 emphasizes businesses that are already operating and have a history, that is where we want to use that program, and then use the 7(a), as Wayne already identified, for working capital and equipment that does not have as long a life perhaps as the bullet-making equipment. But it really serves a distinct purpose, the 504 program.

Chair SNOWE. Ron, with respect to the disaster loan programs—anything else on the 504 or anything else?

Mr. BEW. If I could just make one comment on the 7(a) and 504 programs. That is somewhat of a controversial issue I guess. We did a run of the top 25 industries that both the 7(a) and the 504 programs lend to. I think the top four were about the same; a lot of larger loans for motels, restaurants, convenience stores, and gas stations with convenience stores, if I remember the four correctly.

Both loans, the 7(a) and the 504 were being lent for the same purposes, at least the same industries. There was some overlap.

Ms. D'AGOSTINO. I am pleased to be here to talk about GAO's work on the SBA disaster loan program. We have actually reviewed, and my statement would highlight, first of all, SBA's disaster lending for the 9/11 terrorist attacks. Second, some issues with the performance goals and measures that SBA uses for this program. Third, the loan asset sales, which actually had involved mostly sales of disaster loans. Actually, of those that were sold most, the number of loans not the dollar amount, were disaster home loans.

First, our work showed that SBA was very responsive, flexible, and this was particularly true in light of the unique challenges of 9/11 which caused nationwide economic injury. For 9/11 victims, the SBA modified some terms and lending practices, such as increasing maximum loan amounts and reducing the documentation needed. As Senator Snowe noted in her opening statement, there were a tremendous number of disaster loans approved for 9/11 victims in a very short period of time.

Second, the SBA's performance goals, and measures for the disaster loan program, did not fully capture or give full credit to the programs true performance and results or outcomes. For example, SBA's loan processing performance goal has been set at 21 days within receipt of an application. Yet in both fiscal years 2001 and 2002 SBA actually achieved average times of 13 and 12 days, respectively. These numbers include 9/11 loan processing time.

Also, the SBA does not include some key measures that could help them identify areas in which this fundamentally good program could be even better. For example, rather than surveying all loan applicants, the SBA surveyed only the successful applicants, thereby missing the opportunity to get valuable feedback on how the program could be improved.

The SBA agreed to our recommendations to improve the program's goals and measures and said that it was preparing a customer service survey. Of course, we will be following in our normal recommendation follow-up efforts to see how that is going.

Third, our work showed that SBA's loan asset sales program was very effective at selling loans to the private sector. In the first five loan sales, SBA sold nearly 110,000 loans valued at $4.4 billion. $3.8 billion in disaster loans were included in those sales and 84 percent of those disaster loans were performing loans. The SBA built in some safeguards to protect borrowers whose loans were sold to the private sector. Yet the SBA did not systematically or fully capture those borrowers complaints and concerns. Actually, about one-half of the letters we reviewed in the SBA's files seemed to warrant a closer look by SBA.

SBA headquarters did have a tracking system for borrower complaints but because there was limited guidance to the field. Not all the complaints received in the field offices were actually included in the headquarters tracking system. Further, we found that the SBA may have overstated some of the operational benefits it achieved from the loan sales. For example, the SBA said that loan sales, which began in 1999, would reduce the servicing workload allowing staff to be reallocated to more mission critical areas like

lender oversight, which we discussed yesterday, and business outreach. The servicing workload for disaster loans did decrease to some extent, but servicing and liquidation staff did not get reassigned to non-servicing activity.

Finally, the SBA could not explain a significant decline in the subsidy allowance account for disaster loans. You have a chart that accompanies my testimony that would show what happened in those subsidy loan accounts. In simple terms, and hopefully you will not ask too many detailed questions of me, basically it shows that more was being taken out of this account to cover the costs than had ever been put in it. They also lacked reliable data to determine the overall financial impact of the loan sales, or their impact on the quality of the remaining disaster loan portfolio.

These accounting flaws seriously affected the SBA's budget and financial statements. Ultimately, the overall benefits or cost to the Government from the loan sales remain uncertain. One thing I would mention too is because of the accounting issues, SBA's Auditor did have to withdraw its clean opinion from its audits for fiscal years 2000 and 2001, and they did issue a disclaimer for SBA's fiscal year 2002 financial statement.

Chair SNOWE. What does that mean?

Ms. D'AGOSTINO. That means that for those fiscal years that SBA's financial statements were audited by a certified public accounting firm, and they had issued a clean opinion saying that there were no material problems in these financial statements. What has happened as a result of this work is that the auditor basically issue a disclaimer on their clean opinion that said, those were wrong, do not rely upon those statements. So they changed their position on the statements.

Chair SNOWE. So where does that leave us?

Ms. D'AGOSTINO. The SBA still has a lot of work to do on its financial statements and its accounting situation. I want to say that in response to our findings and recommendations, the SBA is working very diligently to determine the problems and correct them as quickly as possible.

Also, the SBA did agree with our recommendations on tracking borrower complaints and better analyzing the operational benefits from the sales. So that is where the work stands now.

[The prepared statement of Ms. D'Agostino follows :]

United States General Accounting Office

GAO

Testimony
Before the Committee on Small Business and Entrepreneurship, U.S. Senate

For Release on Delivery
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# SMALL BUSINESS ADMINISTRATION

## Observations on the Disaster Loan Program

Statement of Davi M. D'Agostino
Director, Financial Markets and Community Investment

GAO
Accountability * Integrity * Reliability

GAO-03-721T

Madam Chair and Members of the Committee:

I am pleased to be with you today at this roundtable to discuss the role of the Small Business Administration's (SBA) Disaster Loan Program in responding to the September 11, 2001, terrorist attacks, general performance measures for the program, and the effects of SBA's program to sell loans to private investors on disaster loans and their borrowers. As you know, the effects of the September 11 attacks were felt not only in New York but also around our country, with the economic damage occurring in states as far west as California. The unique nature of the attacks and the government's response required SBA to make unprecedented efforts to expand its disaster lending coverage and to be flexible in its efforts to serve those needing assistance. Notwithstanding SBA's extraordinary performance in responding to the September 11 attacks, our work showed that the Disaster Loan Program's performance measures do not fully or adequately reflect SBA's actual performance. In reviewing SBA's loan sales program, which includes disaster loans, we identified three areas needing improvement: tracking borrower inquiries and complaints; sales budgeting and accounting, which affect the reliability of SBA financial statements and budget information; and reporting on the operational benefits of the loan sales.

My remarks today will focus on SBA's (1) response to the September 11 terrorist attacks; (2) performance plans and measures for its Disaster Loan Program; and (3) loan asset sales program, which involves selling disaster and other loans.[1] My comments are based on our recent reports on SBA's Disaster Loan Program (*Small Business Administration: Response to September 11 Victims and Performance Measure for Disaster Lending*, GAO-03-385, Jan. 29, 2003) and loan asset sales program (*Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain*, GAO-03-87, Jan. 3, 2003).[2] Both are available on our Web site: www.gao.gov.

[1]For information on assistance provided to small businesses in the Lower Manhattan area after September 11 by SBA and other government agencies, please see U.S. General Accounting Office, *September 11: Small Business Assistance Provided in Lower Manhattan in Response to the Terrorist Attacks*, GAO-03-88 (Washington, D.C.: Nov. 1, 2002).

[2]Also see April 29, 2003, testimony before the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, U.S. House of Representatives. U.S. General Accounting Office, *Small Business Administration: Loan Accounting and Other Financial Management Issues Impair Accountability*, GAO-03-676T (Washington, D.C.: Apr. 29, 2003).

## Summary

The nature of the September 11 attacks and subsequent government actions presented SBA's Disaster Loan Program with new and difficult challenges. Specifically, small businesses in both the declared disaster areas and around the nation suffered economic injury. SBA sought to respond to the concerns of small businesses in the months following September 11 by extending eligibility for economic injury loans nationwide—a marked change from earlier disasters that affected primarily businesses in one geographic location. In addition, SBA modified both the terms and lending practices of its Disaster Loan Program—for example, by reducing the amount of documentation some borrowers needed to provide. Congress supported these efforts with supplemental appropriations that allowed SBA to offer larger loans to a relatively broad population of victims. By the end of fiscal year 2002, the agency had worked with individuals and businesses in all 50 states, the District of Columbia, and the U.S. territories, approving 9,700 loans totaling $966 million.

We found that SBA had adapted its Disaster Loan Program to respond to the needs of September 11 victims but that SBA's performance measures did not provide congressional decision makers with an accurate description of the program's performance. For example, two of SBA's six performance measures assessed only one discrete step in the loan application and disbursement processes—the application process. In addition, some output measures[3] had not kept up with SBA's actual progress in assisting disaster victims. Further, we identified features in SBA's description of its Disaster Loan Program in the 2002 and 2003 performance plans that made assessing the agency's progress in attaining its strategic goals difficult. For example, although SBA guidance recommended that program goals be outcome oriented, SBA's 2003 performance goal was output oriented.

Our review of SBA's five loan sales from August 1999 to January 2002 revealed that 85 percent of the $4.4 billion in loans sold were disaster assistance home and business loans. SBA established some policies to

[3]According to Office of Management and Budget (OMB) guidance, outputs are the level of activity that can be produced or provided over a given period of time or by a specific date. Outcomes are the intended results, effects, or consequences that occur from carrying out program activities. OMB, *Preparation and Submission of Strategic Plans, Annual Performance Plans, and Program Performance Reports,* Circular No. A-11, Part 6. (Washington, D.C: June 2002).

protect borrowers whose loans were sold. For example, disaster loans less than 2 years old were not sold because they typically required more servicing and sometimes had to be increased to cover exigencies, such as revised physical damage estimates. In trying to determine how borrowers reacted to having their loans sold, we found that SBA relied on borrower inquiries and complaints to determine whether purchasers of the loans were using prudent loan servicing practices. However, information on borrowers' reactions was incomplete because SBA did not have a comprehensive process to capture the inquiries and complaints it receives. Moreover, we found serious issues in SBA's budgeting and accounting for the loans sold, as well as the remainder of the portfolio. For example, SBA incorrectly calculated the accounting losses on the loan sales and lacked reliable financial data to determine the overall financial impact of the sales. In addition, there were significant unexplained declines in the subsidy allowance for the disaster program. We discussed these issues with SBA's auditor who subsequently withdrew its "clean" financial statement audit opinions for fiscal years 2000 and 2001 and disclaimed an opinion for 2002. SBA is continuing to work on resolving its accounting and financial reporting problems. Finally, our analysis of the operational benefits from loan sales suggested that some benefits that SBA reported, such as reductions in servicing and workload volume, either had not yet materialized or were overstated.

## Background

When disasters such as floods, tornadoes, or earthquakes strike, federal, state, and local government agencies coordinate to provide assistance to disaster victims. SBA, through its Disaster Loan Program, is part of this effort. SBA provides loans to households and businesses without credit available elsewhere at a maximum rate of 4 percent and up to a 30-year term. For households or businesses with credit available elsewhere, SBA provides loans at a maximum rate of 8 percent and, for businesses, up to a 3-year term. Business loans are available up to $1.5 million,[4] loans for physical damage to homes are available up to $200,000, and loans for the repair or replacement of personal property are available up to $40,000.

Like other federal programs, SBA's Disaster Loan Program follows performance measurement guidelines under the Government Performance

[4]Even if a business receives a loan to cover both physical damage and economic injury, the total loan amount generally cannot exceed $1.5 million.

and Results Act (GPRA) of 1993.[5] GPRA requires agencies to set multiyear strategic goals in their strategic plans and corresponding annual goals in their performance plans, measure performance toward the achievement of those goals, and report on their progress in their annual performance reports.[6] Annual performance plans are sent to Congress soon after the transmittal of the President's budget and provide a direct linkage between an agency's long-term goals and mission and day-to-day activities. Related annual performance reports describe the degree to which performance goals have been met. Guidance from the Office of Management and Budget (OMB) indicates that performance plans should include measures of outcomes—intended results—when the outcomes can be achieved during the fiscal year covered by the plan. Otherwise, the guidance recognizes that the performance plans will predominantly include measures of outputs (program activities) rather than outcomes.

In 1999, SBA began a loan asset sales program, at the direction of OMB, to reduce the amount of debt the agency owned and serviced. OMB is interested in increasing loan asset sales in order to improve the management of loan assets and to transfer loan servicing responsibilities to the private sector. Our review focused on SBA's first five loan sales through January 2002 in which 110,000 loans with an outstanding balance of $4.4 billion were sold. Approximately 85 percent of the dollar volume of loans SBA sold were disaster assistance loans made directly by SBA, most of which have below-market borrower interest rates. The remaining 15 percent were mostly defaulted 7(a) loans, made by SBA's lending partners (primarily banks).

## SBA Expanded and Changed the Terms of Its Disaster Loan Program in Response to the September 11 Attacks

In the weeks and months following the terrorist attacks, SBA and Congress faced the challenge of responding to the lingering effects of the attacks and subsequent federal actions on small businesses throughout the country. SBA responded first in Lower Manhattan, then expanded its response as additional parts of the New York City and Pentagon areas were designated disaster areas. Ultimately, SBA helped small businesses around the country with disaster lending. In response to the concerns expressed by small businesses, SBA and Congress modified the program, expanding eligibility for economic injury loans to small businesses around

[5] P.L. 103-62, GPRA 1993.

[6] OMB provides guidance on developing these plans in "Preparation and Submission of Strategic Plans, Annual Performance Plans, and Annual Program Performance Reports," Circular No. A-11, Part 6 (Washington, D.C: June 2002).

the country, providing translators for applicants, modifying the size standards for small businesses, expediting the loan approval and disbursement processes, and providing larger loans.

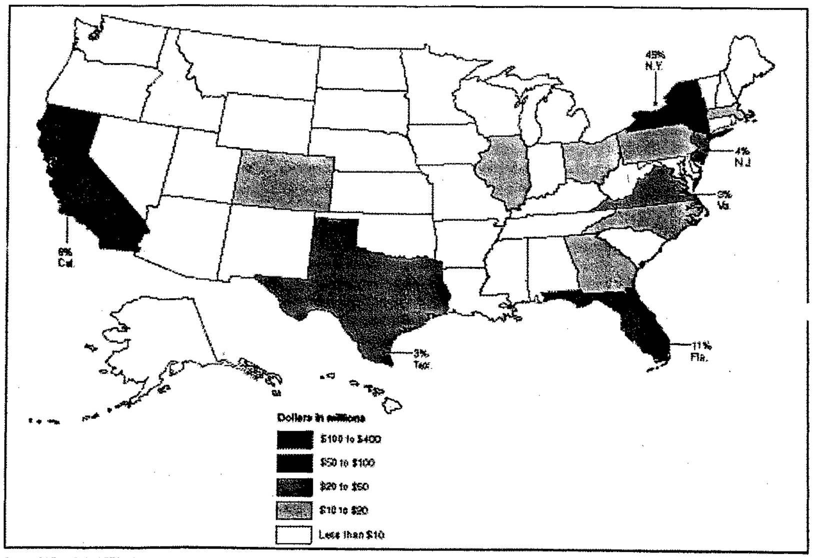
## SBA's Response Covered Small Businesses Nationwide

SBA's response to the terrorist attacks began on September 11, when SBA officials arrived in Lower Manhattan to begin coordinating the agency's efforts. The initial disaster area in New York City and New Jersey eventually expanded to include additional counties in Connecticut, Massachusetts, New Jersey, New York, and Pennsylvania. Maryland, Virginia, and parts of the District of Columbia were also declared disaster areas for SBA purposes. As the United States began to deploy military personnel in response to the terrorist attacks, small businesses nationwide affected by the loss of employees called up as military reservists were eligible to apply for a disaster loan under the Military Reservist Economic Injury Disaster Loan (EIDL) program.[7] Small businesses across the nation that were adversely affected by the lingering effects of the attacks and subsequent government action, such as airport closings and the precipitous drop in tourism, were also eligible to receive disaster loans under SBA's Expanded EIDL program. In essence, the entire country was deemed a disaster area.

More than half the loans went to small businesses outside the area of the attack sites in New York City and at the Pentagon, with businesses in Florida and California receiving the second and third largest share of loans (see fig. 1). Loans ranged from $300 to $1.5 million, with $50,000 as the most frequently disbursed amount (11 percent of all loans). Businesses outside the immediate sites of the attacks generally received slightly more than those close by, in part because they did not have access to the resources available in New York City. The loans were spread among industries, with no single type of business accounting for most of the funds (see fig. 2). The manufacturing sector received the most funds, followed by professional, scientific, and technical services; transportation and warehousing; wholesale trade; and accommodation and food services.

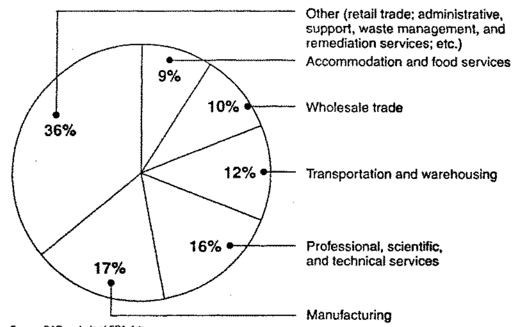
[7]The Military Reservist EIDL program is available to small businesses whenever the government calls military reservists to duty, not just during federally declared disasters.

Figure 1: Geographic Distribution of SBA September 11 Loan Disbursements




Source: GAO analysis of SBA data.

Figure 2: SBA September 11 Business Loan Disbursements, By Industry




Source: GAO analysis of SBA data.

## SBA and Congress Modified the Disaster Loan Program in Response to Complaints from Small Businesses

In the months after the terrorist attacks, small business owners affected by the terrorist attacks presented a number of concerns to Congress about SBA's Disaster Loan Program. SBA officials regarded these comments as valuable feedback and worked with Congress to make several modifications to the program for September 11 victims:

- First, in October 2001, SBA issued regulations to make economic injury disaster loans available to small businesses nationwide, an unprecedented change to the Disaster Loan Program, according to SBA officials. SBA's Expanded EIDL program enabled businesses outside the declared disaster areas to apply for loans to cover "ordinary and necessary" operating expenses that could not be met because of the attacks or related actions of the federal government between September 11 and October 22, 2001.
- Second, SBA printed informational packets in languages such as Spanish and Chinese; provided multilingual staff at its offices who could speak Mandarin Chinese, Croatian, Arabic, and Spanish; and was prepared to send employees with additional language capabilities to New York City.
- Third, in February 2002, SBA modified the size standards for all September 11 loan applicants, allowing borrowers to take advantage of

recent inflation-based adjustments.[8] In addition, in March 2002, SBA increased the size threshold for travel agencies adversely affected by the attacks from $1 million in annual revenues to $3 million.

- Fourth, to expedite loan processing, loan officers streamlined their needs analysis, calculating economic injury loans using the applicant's annual sales and gross margin. By the end of fiscal year 2002, SBA was processing September 11 business loans, on average, in 13 days compared with 16 days for disaster assistance business loans processed in fiscal year 2001. To further expedite disbursement to those in the World Trade Center and Pentagon disaster areas, SBA decreased the amount of documentation needed to disburse up to $50,000.
- Fifth, in January 2002, Congress approved supplemental appropriations for SBA of $150 million, raised the maximum loan amount from $1.5 million to $10 million, and deferred payments and interest for 2 years.[9] Congress also created the Supplemental Terrorist Activity Relief (STAR) program to provide assistance to small businesses affected by the terrorist attacks through SBA's 7(a) loan guaranty program, which is not part of the Disaster Loan Program. Under the STAR program, SBA reduced the fee charged to lenders on new 7(a) loans from 0.50 percent of the outstanding balance of the guaranteed portion of the loan to 0.25 percent. As of the end of fiscal year 2002, SBA had guaranteed about 4,700 STAR loans for $1.8 billion.

Some small businesses affected by the terrorist attacks maintained that SBA's underwriting criteria—for example, collateral requirements—were too restrictive. They testified that SBA had withdrawn their applications because they would not use their homes as collateral. They argued that it was too risky to use their homes as collateral, especially since the survival of their businesses was uncertain. SBA, however, did not change its underwriting criteria for September 11 victims. SBA officials said that the agency makes every effort to approve each application by applying more lenient credit standards than private lenders. However, the officials said

[8] In January 2002, SBA increased the revenue-based thresholds for determining the size of businesses by the rate of inflation. In February 2002, SBA retroactively applied the inflation-adjusted size standards to all businesses applying for September 11 loans, allowing more businesses to seek assistance.

[9] *Emergency Supplemental Appropriations for Recovery and Response to Terrorist Attacks on the United States Act*, 2002 P.L. 107-117 (Emergency Supplemental Act of 2002).

that they adhered to their credit standards to minimize losses and program costs.

SBA data indicate that the 52 percent rate for withdrawing and declining September 11-related loan applications was not out of line when compared with other disasters or with private lenders. The primary reasons SBA identified for withdrawing September 11 loan applications was a lack of Internal Revenue Service (IRS) records to corroborate applicants' income, and applicants' failure to provide additional information SBA had requested. SBA officials said that the most common reasons for declining September 11 loan applications were inability to repay the loan and unsatisfactory credit. According to SBA, these were also the primary reasons for withdrawing or declining nearly two-thirds of all SBA disaster loan applications in fiscal year 2001.

SBA officials believed that many of the complaints about the disaster program resulted from the mismatch between victims' expectations of SBA's disaster program and the nature of the program. SBA officials told us that they tried to minimize public confusion about the nature of the assistance available from SBA by working closely with the media and public officials to provide accurate information about the Disaster Loan Program.

## SBA's Disaster Program Performance Measures Do Not Capture the Scope of the Agency's Efforts

The six performance indicators SBA currently uses to measure the Disaster Loan Program are

- field presence within 3 days of a declaration,[10]
- loans processed within 21 days,
- customer satisfaction rate,
- homes restored to predisaster condition,
- businesses restored to predisaster condition, and

[10]Federal assistance, including all types of SBA disaster loans, is available once the President declares that a major disaster or emergency situation exists. Governors may request a disaster declaration from SBA if damage is minor or moderate and a declaration from the Department of Agriculture if losses are confined to agricultural production. SBA offers only economic injury loans in these last two situations.

- initial loan disbursement within 5 days of receiving closing documents.

We identified several problems with these measures. For example, several are output measures that did not reflect the actual progress being made. Some are proxies that did not accurately represent what was being measured. There is a lack of measures for intermediate or end outcomes, and features in SBA's description of the Disaster Loan Program in its performance plans made assessing the program difficult. Several of the limitations we found had been identified in previous GAO or SBA Inspector General reports and had not been corrected.[11]

## Three Output Measures Do Not Capture Progress

Officials from SBA's Disaster Area Offices (DAO) questioned whether the three output measures—establishing a field presence within 3 days of a disaster declaration, processing loan applications within 21 days, and disbursing initial loan amounts within 5 days of receiving the closing documents—were appropriate indicators of timely service to disaster victims since they did not, for example, capture recent program improvements. SBA has had a 98 percent success rate in meeting the target for establishing a field presence each fiscal year since 1998. Officials from the area offices said that improvements in planning, interagency coordination, and technology enabled them to have staff on site within 1 day of a disaster declaration. According to DAO staff, delays in establishing a field presence generally occurred because SBA was waiting for decisions from state officials.

SBA data and comments from DAO officials suggested that the second output measure—processing loan applications within 21 days of receipt—did not reflect improvements in past performance. For example, SBA aimed for an 80 percent success rate for fiscal year 2001, but the actual time required for processing averaged 13 days in fiscal year 2001 and fell to 12 days in fiscal year 2002. The average time required to process the September 11 business loans was also about 13 days. DAO officials

[11]See U.S. General Accounting Office, *Managing for Results: Opportunities for Continued Improvement in Agencies Performance Plans*, GAO/GGD-99-215 (Washington, D.C.: July 20, 1999); *Small Business Administration: Status of Achieving Key Outcomes and Addressing Major Management Challenges*, GAO-01-792 (Washington, D.C.: June 22, 2001); and *Final Audit Report—Results Act Performance Measurement for the Disaster Assistance Program*, Small Business Administration, Office of the Inspector General, Audit Report 1-06 (Feb. 15 2001).

attributed their faster processing times to several agencywide improvements.

DAO staff also suggested that another measure—the 5-day target for making initial disbursements once closing documents are received—did not reflect past performance and was a low threshold. Before 2002, SBA had an internal goal of ordering disbursements within 3 days of receiving closing documents. When SBA included this measure in the performance plan, the disbursement target was increased to 5 days to accommodate weekends and holidays, because SBA's system for tracking disaster loan processing could not distinguish between workdays and other days. Accustomed to the stricter 3-day standard, staff were able to meet the 5-day standard with ease.

In commenting on a draft of our report, SBA indicated that the output measures were established based on what was determined to be a reasonable level of service in an average year, taking into account the amount of resources required. Because disasters cannot be predicted, officials did not think it would be feasible to adjust production levels based on a single year's performance. Even with some program improvements, they believed it would be very difficult and costly to maintain such levels during periods of multiple major disasters. Although SBA acknowledged that a basis for modifying some output measures might exist, the officials believed that the modifications should be based on an average level of projected activity that takes into consideration some permanent improvements that have been made to the program.

## Two "Outcome" Measures Actually Assessed Outputs

SBA officials indicated that three measures—number of homes restored to predisaster condition, number of businesses restored to predisaster condition, and customer satisfaction—were used to assess the effect, or outcomes of lending to disaster victims. But these "outcome" measures also had limitations. First, while the restoration of homes and businesses was a stated outcome in SBA's strategic and performance plans, SBA did not actually measure the number of homes and businesses restored. Instead, SBA reported on the number of home loans approved as a proxy measure for the number of homes restored to predisaster condition. However, these measures assessed what are actually program outputs (loans approved) rather than stated outcomes (homes and businesses restored). Such proxy measures, then, were likely to have overestimated the number of homes and businesses restored because borrowers might cancel the loan. According to SBA, about 10 percent of the loans approved for September 11 victims were cancelled by borrowers. Third, these

indicators used annual figures that were affected by factors outside of SBA's control, such as the number of disasters that occurred during a given fiscal year. A more useful indicator would be the percentage of homes and businesses receiving loans that were restored each year to pre-disaster conditions.

To measure customer satisfaction, SBA used the results of its survey of successful loan applicants. (SBA also used this survey to evaluate the impact of the program.) But the survey methodology had significant limitations. For example, it measured the satisfaction of only a portion of the customers that the disaster loan program serves. Every DAO director we interviewed indicated that all disaster victims were SBA customers and that a broader population should be surveyed. In 2001, we and the SBA Inspector General made the same suggestion to SBA. As we indicated then, the survey method SBA had been using was likely to produce positively skewed responses. SBA headquarters officials indicated that they were resistant to surveying those who were denied loans because they presumed that the applicants' responses would be negative.

## Some Measures Did Not Assess Intermediate or End Outcomes

Recommendations from SBA's Inspector General, and guidance from us and within SBA, have encouraged the use of outcome measures for this program. But we found that only one of the performance measures SBA was using—customer satisfaction—had the potential to assess a stated outcome of the Disaster Loan Program. The other intended outcomes, which could have been measured annually or biannually, such as jobs retained or housing restored, were not measured.

In addition, SBA had stopped using intermediate outcome measures it had used in the past—loan currency and delinquency rates—to assess the quality of disaster loans. It also had not measured another potential intermediate outcome from the underwriting process—having appropriate insurance. As one DAO official suggested, having coverage such as flood insurance potentially reduces the number of loans required in some disaster-prone areas. As we have reported previously, such insurance can reduce disaster assistance costs and could reduce the effect of a disaster on its victims.[12]

[12]U.S. General Accounting Office, *Disaster Assistance: Information on Federal Costs and Approaches for Reducing Them,* GAO/T-RECD-98-139 (Washington, D.C.: Mar. 26, 1998).

SBA headquarters staff said that while they recognized some of these shortcomings, they had limited ability to develop and use better outcome measures. The staff indicated that the very nature of disaster lending was unpredictable, making it difficult to set performance targets for intermediate or end outcomes. One SBA official said that the agency is reluctant to measure and report intermediate or end outcomes that are outside its control. Other DAO officials indicated that conducting some end outcome measurement methodologies would be expensive—for instance, on-site inspections of a sample of homes and businesses to assess restoration.

We made two recommendations designed to help SBA improve its performance measures for disaster lending. First, we recommended that SBA revise the performance measures to include more outcome measures; assess more significant outputs, such as service to applicants or loan underwriting; report achievements that can be compared over several years, such as percentages; and include performance targets that encourage process improvement rather than maintaining past levels of performance. Second, we recommended that SBA revise and expand its current research to improve its measures and evaluate program impact. To improve its current measures, we suggested that SBA conduct research, such as surveying DAO staff and reviewing relevant literature to identify new outcome measures that could be tested. To evaluate its program impact, SBA needs to ensure that its survey covers all disaster loan applicants and to employ other methods, such as periodic analyses of regional statistics, to assess the economic impact of the program on local communities. SBA generally agreed with our recommendations and said it is addressing our concerns. As of this month, SBA had distributed a customer service survey to help evaluate the Disaster Loan Program's impact and was developing a broader survey. We will follow up with SBA regarding the status of their efforts.

## SBA's Performance Plans Had Limitations

We identified several features of the description of the Disaster Loan Program in the 2002 and 2003 performance plans that make it difficult to assess whether SBA is making progress in attaining its strategic goal. First, between 2002 and 2003, the program's performance goal changed from an outcome-oriented goal (helping families recover from disasters) to an output-oriented goal (streamlining disaster lending) without the required explanation. GPRA requires agencies to explain why they change performance goals, and OMB generally recommends that agencies use goals that are outcome-oriented.

Second, the 2002 and 2003 performance plans do not define the linkages between each program output and each intermediate or end outcome. The plans do not explain how the outputs (disaster loans) are related to the performance indicators (field presence, customer satisfaction, and application processing time frames). Third, the plans do not explain how the performance measures or indicators are related to either program outcomes or outputs. Fourth, performance indicators are added to or dropped from the plans without explanation, making it difficult to understand how and if SBA expects to improve or sustain its loan processing performance.

The performance plans also contain incomplete or inaccurate information on some performance indicators. For example, despite OMB and SBA guidance, validation and verification information on field presence and loan processing measures is omitted, making it difficult to assess the quality of performance data. In addition, the 2003 performance plan indicates that data on the number of homes restored to predisaster condition are based on on-site inspections of homes. However, SBA officials indicated that they use a proxy measure—the number of original home loans approved—as the actual source of data for homes restored to predisaster condition.

We recommended revising the section of the performance plan that covers the Disaster Loan Program to establish direct linkages between each output and outcome and the associated performance measure; accurately describe proxy measures as either outcome or output measures; accurately describe the validation and verification of performance measures; and explain additions, deletions, or changes from the previous year's goals and measures. SBA also agreed with this recommendation. SBA informed us this month that it has undertaken a long-term review of the strategic plan with the aim of revising the performance goals and measures and linking performance to the new plans and goals. We will monitor SBA's progress in implementing this initiative.

## Loan Assets Sales Affect Disaster Loan Borrowers and the Loan Program

A large portion—85 percent in the first 5 sales—of the loans sold are disaster loans previously serviced by SBA. SBA's program to sell disaster loans that it makes directly to borrowers and subsequently services results in private investors owning and servicing the loans over their remaining terms. It was difficult for us to determine the reaction of borrowers whose loans were sold because of incomplete records at SBA. We identified numerous errors in SBA's accounting for the loan sales, including unexplained declines in SBA's loss allowance account for disaster loans.

Until corrected, these errors mean that SBA's subsidy estimates and reestimates for the disaster loan program cannot be relied upon. The operational benefits from selling loans that SBA has claimed may be overstated.

## Information on How Selling Disaster Loans Affects Borrowers Is Incomplete

SBA built in some safeguards to protect borrowers when their loans are sold. But, because SBA's process for documenting and tracking borrower inquiries and complaints has weaknesses, we could not determine how many borrowers had actually contacted SBA with complaints or concerns about the loan sales.

Borrowers have little control over what happens to their loans if SBA decides to sell them. However, SBA has some policies intended to protect the integrity of the programs that provided the loans. SBA's programs, including servicing disaster loans after they are made, are designed to help the borrower recover from a disaster. To protect this public policy goal, SBA's loan sales agreements with purchasers require certification that the investors are qualified to purchase and service the loans and will follow prudent loan servicing practices. The loan sales agreement also prevents purchasers from unilaterally changing the terms and conditions of the loans. In addition, SBA does not sell some disaster loans, including those issued to borrowers currently residing in a federally declared disaster area and those that are less than 2 years old. According to SBA, more servicing is typically required in the first 2 years of a disaster loan—such as changes due to revised physical damage estimates.

Nevertheless, we were not able to validate the way in which borrowers reacted to the loan sales because SBA could not provide a reliable estimate or information on the number of borrowers who had contacted them about their sold loans. Complete and reliable information on borrower complaints is important because SBA officials told us that when a borrower complained about a servicing action they contacted purchasers to collect additional information and determine whether a purchaser was breaching the borrower protections. One reason why SBA's tracking system is ineffective is that borrowers with questions or complaints can call or write to several different SBA offices, or to a representative of Congress. Some SBA field office officials told us that SBA does not provide them with clear guidance on how to respond to or document such complaints. Officials from seven district offices, three servicing centers, and two disaster area offices told us that they had received calls and letters from borrowers who had concerns about loans that had been sold. But the methods for documenting inquiries and complaints varied across

offices, except for congressional letters, which were consistently forwarded to SBA headquarters. In August 2001, SBA began providing a toll-free number for borrowers to call with questions or complaints about loan sales. Borrowers were informed about the toll-free number in a letter telling them how to contact the new owner of their loan. However, field office staff did not receive any guidance regarding the purpose and use of the toll-free number.

Though we were unable to determine how many borrowers have contacted SBA about their sold loans, we reviewed 133 of the 155 written inquiries and complaints documented at headquarters, along with SBA's written responses, to identify the types of questions and problems borrowers may have when their loans are sold. Our analysis showed that almost half (65) were inquiries and concerns about their loans being sold, requests to buy their own loans, or pleas not to have their loans sold. However, 47 of the borrowers complained about a purchaser's servicing action. For example, some letters involved disagreements or frustration with servicing decisions, such as refusing to subordinate or release collateral,[13] or imposing a fee to complete a servicing action such as subordination. Another 18 letters were from borrowers who wanted to defer payments or change the amount of their monthly payments because of financial problems, and felt they were not getting appropriate treatment from the purchasers of their loans.

To address these weaknesses in the loan sales program, we recommended that SBA develop procedures for documenting and processing inquiries and complaints from borrowers, and then provide guidance to the field offices about implementing them. SBA reported to Congress in March 2003 that it would soon issue a procedural notice to its field offices providing a uniform process for handling borrower inquiries and complaints. SBA stated that it also intends to establish an e-mail account for use by all employees to record and forward borrower comments to the asset sales team at headquarters, establish a database to track borrower comments, and enhance a tracking system used for residential borrower inquiries at a servicing center. We will follow up with SBA to monitor its implementation of our recommendations.

[13] "Subordination" occurs when a lender allows a new or existing loan to take a superior lien to another loan. For example, a borrower with an SBA disaster home loan may want SBA or a lender to subordinate the disaster loan to a new or refinanced home mortgage.

## SBA's Accounting for Loan Sales and the Remaining Portfolio Was Flawed

During our review, we found errors that we believe could have significantly affected the reported results in the budget and financial statements for fiscal years 2000 and 2001. Because of errors we identified, SBA's auditor withdrew its clean audit opinions for those years and issued disclaimers of opinion. Moreover, because of these and other financial management issues, the auditor has disclaimed an opinion on SBA's financial statements for 2002. Although this roundtable is not intended to explore the intricacies of accounting, I will briefly comment on our findings, which are fully discussed in the report and testimony cited previously.[14]

SBA incorrectly calculated the accounting losses on the loan sales and lacked reliable financial data to determine the overall financial impact of the sales. Further, because SBA did not analyze the effect of loan sales on its remaining portfolio, its reestimates of loan program costs for the budget and financial statements cannot be relied upon. In addition, SBA could not explain significant declines in its loss allowance account for disaster loans. Until SBA corrects these errors and determines the cause of the precipitous decline in the loss allowance account, the subsidy estimates and reestimates for the disaster loan program cannot be relied on. These errors and the lack of key analyses also mean that congressional decision makers are not receiving accurate financial data to make informed decisions about SBA's budget and the level of appropriations the agency should receive.

We recommended that, before doing more loan asset sales, SBA correct the accounting and budgeting errors and misstatements. And that SBA's Inspector General, with SBA's independent auditors, should assess the impact of the identified errors and determine if the prior audit opinions need to be revised. SBA is working to respond to these recommendations and, as we noted above, the auditor has withdrawn the previously issued clean audit opinions because they could not be relied upon. We will be monitoring SBA's continuing efforts to resolve these issues.

[14]GAO-03-87 and GAO-03-676T.

## Loan Sales Have Reduced SBA's Loan Servicing Volume, but Other Operational Benefits May Be Overstated

SBA reported that loan asset sales had benefited the agency's operations by reducing loan servicing, and that this reduction in loan servicing volume should help allocate resources to other areas necessary to achieving SBA's mission and help the agency to manage its loan portfolio more effectively. Though we found that loan servicing volume had declined for SBA disaster home loan centers, the effect on regular business loans was less clear. Furthermore, despite these reductions in loan servicing volumes, SBA had not yet redeployed staff to more mission-critical activities, such as lender oversight and business outreach. We found that loan sales have mostly reduced the servicing workloads for disaster assistance loans. They have had less impact on servicing workloads for 7(a) business loans, because lenders did not always consent to sell these loans. Because the reduction in loan servicing has involved disaster assistance loans, it was unclear to what extent loan sales would help the agency realign its workforce in the district offices that primarily serve small businesses.

SBA has also reported that the loan sales have prompted borrowers to pay their loans in full, revealed inconsistencies in the application of the agency's servicing procedures, and highlighted weaknesses in its information system. We found some support to show that the loan sales had produced portfolio management efficiencies. But we also found that some of the benefits SBA had reported began before the loan sales program, or could have been caused by other factors. For example, borrowers of disaster loans who refinanced their homes while lower interest rates were available often paid off their disaster loans, even though their disaster loans had low interest rates.

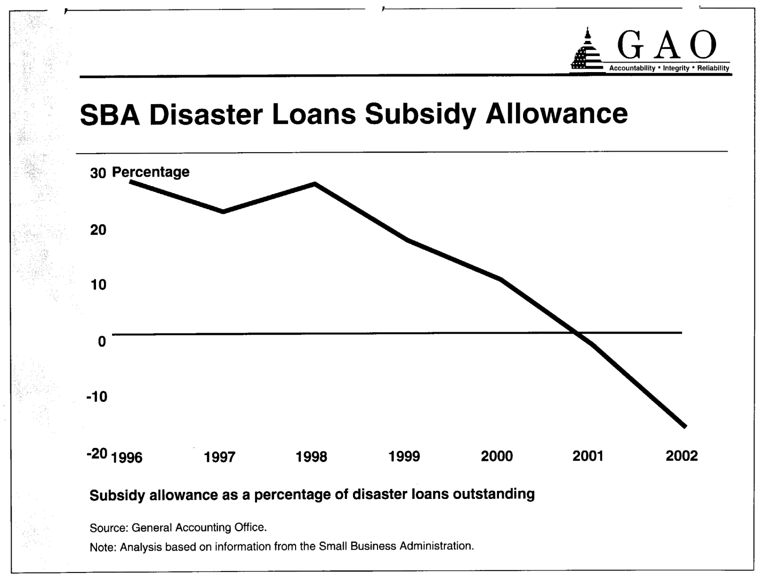
To provide Congress and SBA with a better understanding of the impact of loan sales on SBA's operations, we recommended that SBA conduct a more comprehensive evaluation of the loan sales' impact on the agency and the cost savings from the sales. SBA recently stated that it will conduct such an evaluation.[15] We will follow up with SBA as it addresses our recommendation.

Madam Chair, Members of the Committee, this concludes my prepared statement. I would be happy to answer any questions at this time.

[15] Hector V. Barreto, Administrator, Small Business Administration, Letter to The Honorable Susan Collins, Chair, Committee on Government Affairs, U.S. House of Representatives, March 7, 2003.

## Contacts and Acknowledgments

For information on this statement, please contact Davi D'Agostino, Director, Financial Markets and Community Investment, at (202) 512-8678 or Katie Harris, Assistant Director, at (202) 512-8415. You may also reach them by e-mail at dagostinod@gao.gov or harrism@gao.gov. Other individuals who made key contributions to this testimony or related work include Dan Blair, Kristy Brown, Linda Calbom, Marcia Carlsen, Emily Chalmers, Patricia Donahue, Julia Duquette, David Eisenstadt, and Kay Kuhlman.




Chair SNOWE. I know you said, do not ask too many questions—

Ms. D'AGOSTINO. I actually have somebody here who can answer your questions.

Chair SNOWE. Just to make sure I understand what this chart implies.

Ms. D'AGOSTINO. This is Linda Calbom, Director of Financial Management and Insurance at GAO.

Ms. CALBOM. Basically what that chart is telling you is that SBA's level of their allowance for their subsidy account was up around 20 to 30 percent. You can see this back in 1998 and 1999, which is about where you would expect it to be. In 1999 they changed their disaster model, and at that time they actually decreased some of the—one of the key assumptions which is the amount of time that they expected the loans to be outstanding. As you know, this is a highly subsidized program. It is mostly through an interest subsidy, so the longer the loan is outstanding, the more it costs. In 1999, and this is speculation as far as what we think was one of the major causes of this decline, they reduced the loan term, the expected loan term for those disaster loans from, it used to be 22, 23 years. They reduced it down to more like 16, 17 years, at the same time they started the loan sales. The disaster loans pretty much started in 2000. While the sales did not really cause the problems, the sales brought to light this problem. That in essence they were not putting enough costs into their allowance account to begin covering the real cost of the program.

Now this has been an issue that they have been aware of and have been trying to resolve for sometime. With our work we went in and we were able to say, "Look, this really does not make any sense. You cannot have a negative allowance account for this kind

of a program." Then the auditors said, "Gosh, we guess you are right, so we better reconsider."

Ms. FORBES. So if you were to boil this down, you are basically saying that the subsidy calculation is broken for this program? It sounds similar to problems we heard yesterday, and I know problems the 504 program has.

Ms. CALBOM. This subsidy calculation is definitely broken. As I said, the SBA has hired some consultants, and they believe they are getting down to the bottom of it. It does appear that one of the key things is this loan term issue. You could tell from the loans that were sold, the average loan was 25 years in the five sales we looked at, whereas their assumption was it was 16 to 17 years. So, yes, it is broken. That is not the only problem. There are some other problems—I will not get into them but very complicated problems—that also were leading to the decline in the account, the very unnatural decline in the account. Once they get this all resolved and figure out what assumptions need to be corrected, and they plug that back into their model—not that the model is broken per se, but it is the assumptions that went into the model. Once they get the right assumptions figured out, then they are going to need to go in and do a big re-estimate to bring the account back up to a more normal balance.

Chair SNOWE. Is that directly as a result of the changes that occurred in 1999?

Ms. CALBOM. I am not sure. That is speculation we had because—part of it I think is—because when they went to redo their calculation of their loan term they used a straight average apparently instead of a weighted average. So I think that is part of the problem.

Ms. FORBES. Was that when the Administration's budget assumed that all the loans would be sold? Have you tracked it with what the budget proposals were to see, if what the budget was proposing in a given year was then incorporated into the subsidy model even though Congress did not act on what the proposal was?

Ms. CALBOM. I am not sure about that.

Ms. FORBES. We would be interested in seeing some sort of follow-up on that.

Chair SNOWE. I agree. I think we need to follow-up on this issue and find out—Herb, do you have any comments? I have to go because we have a vote.

Mr. MITCHELL. I do not have any particular comments on that issue. That is obviously an issue for GAO, OMB, and the CFO to address.

But just briefly, the disaster assistance program, while we have certainly been successful, has had a lot of cooperation from this Committee and the Congress. As you well know, disasters are not predictable and we project future needs based on the 5-year average. What happens when we do have emergency events like 9/11 and events that we have had in the past? We have gotten excellent support from this Committee and the Committee in the House to develop supplemental packages and legislation that give us the flexibility to address the needs of disaster victims.

9/11 is unique in that historically about 80 percent of all disaster loans are to homeowners and renters as to opposed to businesses.

That was reversed with 9/11. But we just simply appreciate the support that we have gotten as well.

Chair SNOWE. We appreciate that, Herb. Thank you.

I have to depart and staff is going to take over, Mark, Greg, and Patty are here. Feel free to follow-up on any of the issues.

I really do appreciate the time that you have given here today in participating in this roundtable. It will be very helpful, useful, and constructive as we proceed in the reauthorization.

I want to express my appreciation to each and every one of you for being here today, and those of you here yesterday. Thank you. See you in Caribou.

Mr. FOREN. In fact, I am going up there Tuesday to work with a company that is a distributor of fasteners, working on the Humvees that are being rehabbed at Loring. We have some inventory in Philly we are going to see if we cannot put to work up there.

Chair SNOWE. We appreciate that. Thank you.

Mr. FOREN. Is the snow gone yet?

Chair SNOWE. Not quite.

Ms. FORBES. Herb, I have a follow-on question regarding 9/11 loans. You are intending to sell them as well, in the normal course? I do not mean you personally, but the Administration.

Mr. MITCHELL. I am not sure. At this point, the asset sales program has been put on hold until we can review a lot of the financial issues.

Ms. FORBES. That is the entire asset sales program?

Mr. MITCHELL. Yes, that is correct.

Ms. FORBES. Let us say it gets back on track and you were going to sell them. What year would that come up?

Mr. MITCHELL. I am not sure. I am not in a position to address that.

Ms. FORBES. If it gets back on track, would you please let us know, because obviously there are a lot of these loans made across the country, and we often get the complaints when the loans are sold.

Mr. MITCHELL. Sure, we would be glad to.

Mr. WARREN. Davi.

Ms. D'AGOSTINO. Sure. Basically one of the protections, the borrower protections, that I mentioned in my brief oral summary was that SBA had been waiting for 2 years after disaster loans had been made before they put them under consideration for the Loan Asset Sales Program. The SBA waited 2 years because they thought that 2 years was a reasonable amount of time, any changes to the loans would have probably been made by then. Additional assessments of physical damage, et cetera, would have been made within the 2-year period.

That is the thinking, I think, the SBA had behind this 2 year date. I do not know if it is applicable to 9/11 victims and what have you, but that is pretty much their criteria.

Ms. FORBES. The Bill that established the 9/11 loans, was a bill that this Committee worked on and it had a lot of co-sponsors among our Members. We were trying to expand that two years to a 4-year waiting period. So that is one of the reasons why I am asking.

Mr. WARREN. If I can go back a little bit more broadly to the work that GAO has done, and Herb, your input would be real helpful here. One of the issues that was raised in these asset sales was that there was not a good mechanism for keeping track of the complaints from the outside. We certainly have heard a lot about them.

Has anything been done or thought about, in terms of trying to put that type of a system in place?

Mr. BEW. I will answer that.

I think the complaints, to put it in perspective, to date 170,000 loans have been sold and 350 have complaints. Yes, we have instituted a tracking system. I think there was a disconnect between the complaints coming into Washington and the complaints coming into the field. Now we have connected that together, put in an 800-number, and I think there is also a website. We have done three things to correct the tracking.

Mr. WARREN. How were complaints recorded prior to that?

Mr. BEW. I think some were coming into the districts and some were coming into the headquarters. When they came into headquarters, we had a person assigned to contact the original lending entity and address it.

Mr. WARREN. Davi, did you want to add something?

Ms. D'AGOSTINO. Yes. I think there was a disconnect in the guidance that was out in the field. The field people were very conscious about trying to follow-up and respond to the complaints and inquiries. A lot of them are also just inquiries, like why are you selling my loan?

So it is not all complaints about how they are being treated by the private sector purchaser.

But basically, I think what was happening was only the congressional-backed complaints were being sent from the field to headquarters. So that if there were any people who did not contact their Congressman or Senator, and have that going on, their complaints did not make it to Washington. They did not have enough insight into that.

But I think the SBA has clarified the guidance. We have not gone in and followed up yet, but from what we understand they have put out better guidance and have created a web-based system.

Mr. WARREN. From your review of those complaints, can you give us some idea of what the most common causes were?

Ms. D'AGOSTINO. I can get back with you on that. I do know that about half of the ones we saw, there were about 155 complaints. We looked at 130-some complaints. About half of those were complaints surrounding the way the purchaser was dealing with them. They may not have been getting the same kind of treatment that they had gotten from the SBA, in terms of changing terms, things like that, subordination.

But I can look into whether there was any particular trend. I am not sure that there was, but I will get back to you on that.

Mr. WARREN. Thank you.

Ms. FORBES. So Ron, that 350 number is including the other complaints that GAO located when they did their work? Or that was your original number?

Mr. BEW. I believe that includes it. I am not 100 percent sure on that, but I will check.

Ms. FORBES. Can you just provide that for the record, please? Thanks.

Mr. WARREN. Going a little more broadly to Herb, are there plans to try to offer more in the way of disaster application or disaster loan applications online?

Mr. MITCHELL. Right now we do have a project underway to completely automate the disaster loan project. We have a contractor in place. In fact, we have a team of about 20 people that are working on that project right now. It is estimated that we will have the first iteration of that available in June 2004 with a capability for applicants to apply online.

The other thing that we are doing as well, is that we will have remote capability. For example, if you are in the disaster area where we have field locations, and obviously if your property has been destroyed, you will be able to come into these centers to apply online, or to give that information to us. If you are a homeowner, you can apply by telephone, or we will be able to take the application online.

Mr. WARREN. Any other comments on the disaster loan area?

Why don't we move on to our final topic which is the SBA's investment capital areas. We know from a long history that these programs, namely we are speaking of the SBIC Program and the New Markets Venture Capital Program, that they have offered financing and investment opportunities that promote economic development, job creation and retention, and business expansion and growth. They have been incredibly important in this country.

We would like to try to highlight this morning some of the lessons learned and look for ways that we can apply those lessons to improve the programs going forward. With that, who would like to start? Lee, would you like the honor?

Mr. MERCER. Thank you.

I am just going to briefly run over the issues, as we see them at NASBIC, and I will be submitting a formal statement. But I wanted to wait and see what the flavor was to make sure that I addressed all the issues that might be of concern. Think twice and write once, somebody once told me. I guess carpenters measure twice and cut once.

So the issues, very briefly. Obviously, we hope to have a continued zero subsidy rate, which means authorization is extremely important to us, as well, this year. The Administration has asked for levels, fiscal year 2004 levels of $3 billion in debenture authority and $4 billion for participating security authority and we concur with that.

If there is to be a 3-year authorization, as we suggested in the House testimony, I think market conditions are such that if those numbers were just bumped up maybe $250 million per year, that would more than cover, we think, the demand right now.

As everybody who reads the financial pages knows, venture capital is shrinking dramatically. The good news is that the SBIC Program is not shrinking anywhere near as dramatically as the strictly private area. In fact, the SBA would be able to talk about the number of people who are in line to become licensees. So that is the good news.

In order to maintain a zero subsidy rate in the participating security program, it would be required to increase the statutory rate that says not to exceed 1.38 percent, which is a direct payment to the SBA, to 1.454 percent, I believe. We suggest that the number be raised not to exceed 1.5 percent.

It should be noted that the increase that is required is not related to a change in assumptions. It is related really to the fact that because 10-year Treasury rates are so low, the profit participation that participating security SBICs have to pay the Government, which are directly related to that rate, are much lower. So when you are filling the subsidy bowl, if you will, you have got to get your money from someplace. If you are getting less money from the SBICs in terms of profit, you have to get more from SBICs in a preferred return. So the SBIC is not being punished, it is kind of being taken from one pot and put in the other pot.

Unrelated to reauthorization—I just want to highlight this right in the middle—is our proposal with regard to UBTI and we feel extremely fortunate that Senator Snowe and Senator Kerry are such strong supporters of that. It has nothing to do with the reauthorization bill but as the staff in the Senate Finance Committee becomes increasingly unavailable as the bill is written, we are hopeful that staff on the Small Business Committee can be in direct contact with staff on the Finance Committee and perhaps urge them to consider putting that provision in the Chair's mark. I get calls, more and more calls every day, about the debenture program. Sometimes good timing is everything.

The tax-exempted investors, the pension programs, the pension funds, really do have an appetite for what are considered safer investments in the venture capital area. The debenture program is certainly far less volatile than the participating security program, and fills a real need. I think we have a great opportunity there.

Going back to reauthorization, an issue that we hope to address is what we think is a congressional clarification in the area of capital impairment. As you know, there is a statutory imperative that in advancing leverage to an SBIC that the SBA has to make a decision as to whether or not advancing that additional leverage will create an unreasonable risk of loss to the Government. We are not suggesting that that statutory imperative be changed.

However, ending a support of leverage is a little bit different than taking some of the actions that over the years the SBA has decided to go along with. For instance, the SBA asserts a right to, at a time when it stops supporting an SBIC, to reach out for any private capital commitments that have yet to be paid into the SBIC, and require them to be paid in and then paid directly to the SBA to pay down leverage without having first been invested in small businesses.

I just want to read you from an investor. This is the Arkansas Development Finance Authority, which has authority to invest in venture capital funds and is considering an investment in an SBIC. They may not do it.

We are very concerned with the SBA's unilateral right or the assertive right to call outstanding portion of private capital commitment to the SBIC and require that it be applied not to new or existing investments, but to outstanding leverage. We view ourselves

no different than private investors who expect their money, less fees, to be invested in small businesses not to be used to repay SBA. We understand that the SBA has a preferred position with respect to return of capital upon dissolution. However, that is much different from an expectation that private capital will never be deployed as investment capital that carries with it a potential for both return and gain.

I will submit that for the record.

[The information follows:]

NASBIC
America's Small Business Partners

**Statement Of**

**Lee W. Mercer**

**Filed May 8, 2003**
**With The**

# United States Senate
# Committee on Small Business and Entrepreneurship

**Following Its Roundtable Of**

**May 1, 2003**

**National Association of Small Business Investment Companies**
666 11th Street • N.W. • Suite 750 • Washington, • DC 20001
Tel: 202.628.5055 • Fax 202.628.5080
www.nasbic.org
E-mail: nasbic@nasbic.org

Senator Snowe, Senator Kerry, and members of the Committee

Thank you for the opportunity that you accorded us to participate in the Roundtable held May 1, 2003 that addressed, among others, issues related to reauthorization of the Small Business Investment Company program. In accordance with your invitation to submit materials and suggestions for the record, we respectfully submit the following statement.

**Reauthorization Period & Maximum Leverage Levels**

Among other items to be addressed, the Committee will address the period for which the reauthorization will apply and the maximum leverage levels that will be apply in each of the years for which the program is reauthorized. In this regard, we recommend that the program be reauthorized for three years as has been the general rule in the past.

As to maximum leverage levels, we support those proposed in the President's budget for FY 2004: $3.0 billion for Debenture leverage and $4.0 billion for Participating Security leverage. Those amounts should be sufficient to meet the requirements of existing SBICs and newly licensed SBICs that will rely on that authority to make investments. If the reauthorization period is three years, we suggest that authority be increased by $250 million in each of the programs in each of the additional years (FY 2005 and FY 2006) to which the reauthorization would apply. Thus, Debenture authority would increase to a maximum of $3.5 billion in FY 2006, Participating Security authority to $4.5 billion. Under current conditions, that authority should be sufficient to meet demand. What we hope we will never see is maximum authority serving as a cap that would keep new private capital from being invested in new SBICs.For the Debenture program, §303(b) of the Small Business Investment Act (SBIA) provides that one of the fees is annual interest to be paid directly to SBA for leverage drawn with respect to an applicable year's leverage authority. The interest rate varies from year-to-year as required to keep the subsidy rate at "zero" for Debenture appropriation purposes; provided, however, that the rate may not exceed 1.0% per annum. For Debenture leverage to be drawn against FY 2004 authority, that rate required to maintain the zero subsidy rate will be 0.855% per annum, down slightly from the FY 2003 rate of 0.887% per annum. No change in the law will be required.

SBIA §303(g)(2) provides the per annum counterpart for the Participating Security program. The section provides that a prioritized payment rate of not to exceed 1.38% per annum on any outstanding leverage related to the annual leverage authority in question shall be paid directly to SBA's account to keep the subsidy rate at "zero" for Participating Security appropriation purposes. For leverage related to FY 2003 authority, the required rate is 1.311% per annum. For FY 2004 leverage authority the required rate will be 1.454% per annum, 0.074% greater than current statutory authority. Thus, for implementation of the President's budget as submitted, the authority of SBIA §303(g)(2) must be increased legislatively by 0.074% at a minimum.

The reason the §303(g)(2) rate must be increased this year has nothing to do with assumption of increased losses in the program. Rather, it is because the profit sharing rate that Participating Security SBICs must pay SBA falls as the 10-year Treasury bond rate falls. At current projections for the 10-year rate, the profit share rate is at its lowest point. In essence, all that is happening this year is a reduction in one rate element and a related increase in another.

May 1, 2003

In reauthorization testimony earlier this year before the House Small Business Committee, we suggested increasing the §303(g)(2) "not to exceed" rate to 1.5% per annum as part of the reauthorization process later in the year. That is the same level we suggested in FY 2002. At the May 1st Roundtable, I was asked if the industry would support a slightly higher increase, perhaps a rate of not to exceed 1.7%. Upon reflection, we do believe that maximum rate would be reasonable under the circumstances. It is within the ability of SBICs to pay given current market conditions and would not in any way increase the amount paid by small businesses for Participating Security SBIC financing. Total annual cost of leverage has been much higher historically than it is today. The estimated total cost of Participating Security leverage for the next year is approximately 6.5% per annum. This compares to the average for the life of the program of 7.84% per annum. Participating Security SBICs using FY 2004 leverage will be well positioned to contribute to the economic revival so important to our country.

**Changes In the Small Business Investment Act of 1958 That Would Make More Capital Available To Small Businesses and Retain Successful SBIC Managers In The Program.**

By SBA estimate, during this period of recession, SBICs are making approximately 60% of the venture capital investments (by number, not dollar amount) that are being made in the U.S. at the current time. Yet SBICs are constrained by the maximum amount of leverage that any one or group of co-managed SBICs can have outstanding at any one time. In FY 2003, that limit is $113.4 million. The limit on a per fund basis is not the problem. The problem occurs when a successful management team forms a second (or third SBIC) while leverage is still outstanding in the preceding SBIC. This can occur often, particularly in periods such as this when it takes longer and longer for the small businesses the SBICs are supporting to grow to the extent that the SBIC can obtain a realization on its investments. It is that realization that allows the SBIC to pay down leverage in one fund and re-draw it in another fund that has been licensed by SBA.

Many successful managers of larger SBICs (those with more than $35 million in private capital) will be forced to leave the program unless this problem is solved. While these funds constitute only about 15% of SBICs, they are an important part of the overall financing ability of the SBIC program. Their funds sizes, including projected leverage, tend to be no larger than $150 million, still very small in terms of venture capital funds. In contrast, according to Venture Economics, in 2001, 65% of all venture capital raised went to funds with more than $250 million.

To address the issue and a related issue of providing ample capital for "smaller enterprises," we suggest the following changes to the Small Business Investment Act—requiring changes in §§303(b)(2), (b)(4), and (d) of the Act:

1. Set maximum leverage for any single SBIC at $115 million and eliminate the annual increase equal to the percentage increase in the Consumer Price Index. The FY 2003 maximum is $113.4 million, and $115 million is a reasonable estimate of next year's level under current law. Eliminating the automatic CPI increase will maintain a reasonable maximum for the next three years and give Congress greater control on the maximum leverage in the future.

2. Set maximum leverage for any group of co-managed SBICs at $150 million—30% more than the single fund maximum—to provide for adequate leverage when management

May 1, 2003

teams are transitioning from one fund to another pursuant to a new license granted by SBA. Again, we suggest eliminating the automatic CPI adjustment.

3. Change the requirement that 20% of all investments plus 100% of investments made with leverage in excess of $90 million be made in "smaller enterprises" (a subset of qualifying "small business concerns") to one requiring that 25% of all investments be made in "smaller enterprises." The change would simplify record keeping and examinations, increase mandatory investments in "smaller enterprises" by the large majority of SBICs that do not exceed the leverage cap, and ensure that "smaller enterprises" are well represented in the small percentage of large SBIC portfolios without making the mandate unworkable over time from an investment focus perspective. In smaller SBICs, the likelihood is that significantly more than 25% will be invested in "smaller enterprises."

The above approach would be easier to administer than the approach we suggested in our testimony before the House Small Business Committee. That approach would see relief from the cap only for investments in manufacturing companies. The approach suggested above would also see more funds flow to manufacturing companies, but without distorting general market forces and requiring additional reporting on the part of SBICs or analysis on the part of SBA.

There would be no increase in risk to the government since all leverage would continue to be supported by the required ratios of private capital, capital that is always at risk first before there is any possibility of loss to the government. In addition, there would be no change in the SBA's right to deny leverage in those cases in which SBA determined there was an unreasonable risk of loss involved. Finally, eliminating the automatic increase in maximum leverage each year in favor of provisions deemed reasonable for the reauthorization period will simplify the regulatory process and return control of the issue to Congress as part of the periodic reauthorization process.

To implement the suggested changes, we propose that the following changes be made to the Small Business Investment Act:

- Amend §303(b)(2)(A) and (b)(2)(B) to read as follows:

  (2) MAXIMUM LEVERAGE

    (A) IN GENERAL —The maximum amount of outstanding leverage made available to any one company licensed under section 301(c) of this Act may not exceed 300% of private capital—to a maximum of $115,000,000.

    (B) MULTIPLE LICENSEES —Except as may be provided on a case-by-case basis in accordance with such additional terms and conditions as the Administrator may deem appropriate, the maximum amount of outstanding leverage made available to two or more companies licensed under section 301(c) of this Act that are commonly controlled (as determined by the Administrator) may not exceed $150,000,000.

- Delete §303(b)(4) as no longer required to address leverage maximum leverage limits.

May 1, 2003

- Strike all of §303(d) and amend it to read as follows:

  (d) INVESTMENTS IN SMALLER ENTERPRISES —The Administrator shall require each licensee, as a condition of an application for leverage, to certify in writing that not less than 25% of the licensee's aggregate dollar amount of financings will be provide to smaller enterprises.

**Suggested Changes In The Small Business Investment Act Of 1958 That Will Increase Support Of Private Investors And The Ability Of SBICs To Raise Private Capital**

To clarify congressional intent and to encourage more private investors, particularly institutional investors, to invest in the SBIC program, we suggest an amendment to SBIA §303(e), the section of the Act that deals with "Capital Impairment." The section requires that SBA, as a condition of approving a request for leverage by any SBIC, make a determination that "the private capital of the licensee has not been impaired to such an extent that the issuance of additional leverage would create or otherwise contribute to an unreasonable risk of default or loss to the Federal Government." SBA has construed §303(e) as requiring not only that a finding of capital impairment (as defined by SBA) might preclude advancing additional leverage, but also that it is a violation of SBA promulgated regulations that can lead to imposition of operating restrictions, denial of the right to use remaining private capital for investment purposes, and actual liquidation of the SBIC at the direction of and upon terms set by SBA—even in cases where there has been no other violation of the law or regulations and the SBIC has done nothing other than invest in accordance with the provisions of the business plan approved by SBA during the licensing process. Among the conditions that SBA asserts it can impose is a requirement that the SBIC call any remaining private capital for the sole purpose of retiring outstanding leverage rather than supporting investments in small businesses.

While capital impairment may be a permissible reason for denying an SBIC new leverage—for extending any new government-guaranteed capital—we do not believe it was congressional intent that capital impairment by itself, absent other regulatory violations, be a reason to shut down an SBIC or deny the use of its private capital for original small business investment purposes. Other than the reference to capita impairment in §303(e), there is no other reference to capital impairment in the SBIA. We believe the intent was to give SBA a tool to help it judge whether or not it would advance more leverage to an SBIC, but not one that would permit SBA to punish the SBIC for simply having its capital eroded by investment losses. Those potential losses relate to investments in small businesses. While the money may not be returned to the SBIC, it nevertheless was put to its intended purpose. Whether or not the losses will be realized over time cannot be known only by looking at a value at mid-point in the life of an SBIC.

SBIA §301(c)(3)(B)(iii) and §302(a)(3)(B) stress SBA's right to make the judgment during the licensing process and upon leverage requests as to whether or not to support an SBIC. However, we believe no section gives SBA the explicit authority to anticipate that an SBIC will be unable to meet its obligations with respect to leverage that has already been issued and to declare this unilateral anticipation a condition of default that justifies restricted operations or liquidation. Failure to pay Debenture interest, a prioritized payment due from a profitable PS fund, or the actual principal of a security *when due* are conditions of default that should (and do) permit SBA action, but arbitrary, SBA-defined capital impairment ratios should be excluded from that list.

May 1, 2003

In Participating Security SBICs, and in Debenture SBICs to a lesser degree, the very nature of investing can create significant conditions of capital impairment during the life of the fund. Depending on the type of investments made by a fund (e.g., start-up, later stage, technology, debt, or equity—all approved by SBA in the licensing process), capital impairment can be considerable in a fund that will ultimately prove to be profitable. If SBA is the judge able to make a unilateral, governmental decision on when to shut down a fund in advance of the due date of outstanding securities, private investor support of the program will begin to erode since it will be seen as a repudiation of the very venture capital model upon which the program is based and a transfer of investment decisions from the private fund managers to the SBA.

There is no question but that some SBICs will lose money. Bad things can and do happen to good people. Individual venture capital funds can lose money. However, SBA is an investor in hundreds of SBICs. Over time, dollar cost averaging will work to the advantage of SBA just as it does for all sophisticated investors. Licensing requirements are strict, private capital is at risk first, and SBA can refuse to issue new leverage based on calculation of capital impairment. All of that is reasonable in the context of the program. However, if SBA severely restricts or liquidates SBICs in mid stream simply because of capital impairment ratios, private investors will have little reason to support the program, particularly the Participating Security program. This is particularly true if SBA couples restrictions with a call of private capital to pay itself rather than to see the money invested in the small businesses that make up the SBIC portfolio. Private investors can accept losing their money if it has been invested in small businesses. They cannot accept simply paying their capital directly to SBA. The attached copy of the March 23, 2003 letter from the Arkansas Development Finance Authority underscores the point—a point also of concern to all banks that are a significant source of capital for SBICs

To clarify congressional intent, we suggest that §303(e) of the Small Business Investment Act be amended to include a new subsection (3)—which would read as follows:

> "(3) Notwithstanding the Administrator's right under subsection (2) to refuse to grant additional leverage to a licensee based on the degree to which the licensee's private capital has been impaired, that degree of impairment shall not be the basis, in whole or in part, for any action by the Administrator to restrict the operations of the licensee or to direct the use of the licensee's remaining capital to any purposes other than the investment purposes for which the licensee was licensed. This provision shall not prevent the Administrator from taking actions to restrict the operations of, or liquidate a licensee for failure to comply with any other provision of the law or regulations promulgated by the Administrator under authority of this Act."

We believe that the above clarification is necessary for the long-term strength of the program and is one that will make the SBIC program a very attractive program for institutional investors who, for the most part, have not invested heavily in SBICs. Coupled with what we hope will eventual success in your efforts, for which we are very grateful, to eliminate the Unrelated Business Taxable Income disincentive applicable to Debenture SBICs, we believe that the program will attract significant new sources of capital, capital that will be put to work supporting U.S. small business entrepreneurs in a critical economic period.

May 1, 2003

**<u>Suggested Changes In the Small Business Investment Act of 1958 That Will Strengthen SBA's Position With Respect To Leverage Advanced To Participating Security SBICs</u>**

As we have suggested to SBA, we believe that the risk of loss to the government in the Participating Security program can be reduced by amending SBIA §303(g)(9) in such a way that does not erode private investor support for the program. We believe that the change we suggest will have a very positive impact on the subsidy rate, making it possible to remain at a "zero" subsidy rate without the necessity of increasing other fees. The change will increase the SBA portion of any distribution from retained earnings by giving SBA the right—after there has been repayment of prioritized payments and a tax distribution—to remain in accordance with existing law—to the same pro rata share it is entitled to in the case of a distribution of (return of) capital.

Specifically, we propose that §303(g)(9) be amended to provide as follows:

(9) After making any distribution as provided in paragraph (8), a company with participating securities outstanding may distribute the balance of income to its investors, ~~specifically including the Administration, in the per centums specified in Paragraph (11),~~ if there are no accumulated and unpaid prioritized payments, ~~and if all amounts sue the Administration pursuant to paragraph (11) have been paid in full,~~ subject to the following conditions:

(A) <u>Any amounts received by the Administration under this paragraph and paragraph (8) shall be applied first as prepayment of the principal amount of the outstanding participating securities or debentures of the company at the time of such distribution and then to the profit participation as provided in paragraph (11).</u>

(B) <u>Any distributions under this paragraph shall be made to private investors and to the Administration in the ratio of private capital to leverage as of the date immediately preceding the distribution until the outstanding participating securities or debentures of the company shall have been paid in full, after which, any remaining distributions under this paragraph shall be made to private investors and to the Administration in the ratio that is provided for the distributions of profits in paragraph (11).</u>

(C) <u>The Administrator shall adopt such regulations as are required to assure that management fees for the company are not unreasonably reduced due reduction in combined capital as a result of distributions made under this paragraph.</u>

(D) <u>Section To Be Deleted</u>

May 1, 2003

**The SBIC Program Is A Model Partnership Between SBA, SBIC Fund Managers, And Private Investors—One That Is Making A Real Difference For U.S. Small Business.**

In closing, I would like to highlight several facts that I believe support the above caption.

1. SBICs are an important part of our national economic recovery. SBA estimates that SBICs currently account for 60% of all venture capital investments—by number of investments. For comparison, in 1997 the number was 38%. The increase is likely to grow in the face of the substantial and continuing contraction in overall venture capital. To illustrate, the number of all annual venture capital investment transactions has dropped by 60% since the high water mark of FY 2000, but the number of SBIC investment transactions has dropped by just 14% over the same period. This underscores the countercyclical nature of the SBIC program and the role it will play in the recovery.

2. SBICs are proving their value as steady and reliable sources of venture capital for U.S. small business entrepreneurs. For the fiscal year ended September 30, 2002, SBICs invested $2.7 billion in 1,979 U.S small businesses. While down 40% from the previous year, the total compares with a drop of 54% in all venture capital dollars invested for the period. The biggest drop in SBIC dollars invested was in those made by unleveraged bank SBICs—a 63% drop compared to only a 16% drop in investments made by leveraged funds. Bank SBIC investments have fallen because of economic conditions and because banks can now make venture capital investments out of funds established under Gramm-Leach-Bliley authority. Finally, and of the greatest importance, while SBIC dollars invested fell 40%, the number of companies financed dropped only by 12% (from 2,254 to 1,979), indicating that much of the dollar fall can be attributed to lower valuations of companies securing financing. Given the major contraction in the economy, a fall of just 12% in the number of companies supported by SBICs was a positive result.

3. SBICs are a significant source of capital for new businesses, with 48% of all FY 2002 investments made in companies less than three years old.

4. The average size of investments by all SBICs was less than $1.0 million, while investments by non-SBIC funds averaged about $9.0 million for the same period.

5. SBICs invest in areas that are traditionally underserved by non-SBIC venture capital firms. SBICs invest in virtually every state—48 of 50 in FY'02—and are an important source of capital for businesses located in Low- and Moderate-Income (LMI) areas as defined by the government. In FY'02, LMI investments by SBICs totaled $725 million—27% of all SBIC FY'02 investments. The 27% total was up from 22% in FY 2001—a percentage increase of 23% for LMI businesses.

6. Regarding employment, average employment at SBIC-financed companies in FY'02 was 157. The median number of employees was 29. Based on the average, SBIC-financed companies employed approximately 310,000 individuals in FY'02. With growing capital resources, SBICs are ready to build on that number in the years ahead.

May 1, 2003

7. Currently 441 SBICs are managing $20.6 billion in capital resources, up 10% from $18.8 billion at year-end FY 2001. The increase is significant given the contraction in all other sources of venture capital. During FY'02, private investors committed $800 million in new private capital to the 41 new SBICs licensed in FY 2002. The backlog of current license applications at SBA and the rate at which new applications are being received make it likely that as many as 50 new funds will be licensed in FY 2003. This will ensure the continued flow of critical venture capital to the fast-growing U.S. small businesses that are the foundation of U.S. job creation and economic growth.

8. What will FY 2003 results show? An extrapolation from investment data through April 18, 2003 indicates that dollars invested will likely remain level, but that there will be a substantial increase in the number of companies receiving financing—perhaps as many as 3,000. What can be said with certainty is that the program is strong and that there is continued growing interest in the program among experienced venture capital management teams. That is good for the program and U.S. small businesses.

Thank you for your support of the SBIC program and for your consideration of our proposals. We enjoy a very strong and positive working relationship with SBA and believe the program is on a strong footing. We believe the changes we have suggested will make the program stronger still and even more effective in supporting U.S. small businesses in the future.

May 1, 2003

ADFA

**ARKANSAS DEVELOPMENT FINANCE AUTHORITY**
423 MAIN STREET, SUITE 500
P.O. BOX 8023
LITTLE ROCK, AR 72203-8023

Mr. David Latham
Partner
Delta Venture Partners I, L.P.
8000 Centerview Parkway, St 100
Cordova, Tennessee 38018

March 28, 2003

Dear David,

As a follow-up to our conversations last week I wanted to make you aware of ADFA's primary concern with the SBIC program. As you know the Arkansas Venture Capital Investment Act of 2001 provides $60 million dollars of credits to allow us to raise capital to invest in venture funds. ADFA has added another $10 million for a total of $70 million for allocation to venture capital groups.

ADFA has selected the U.S. Partnership for State Investment (USPSI) as our institutional fund manager. With USPSI acting on our behalf as the partner in a venture capital partnership our goal is obviously to see a strong return on our invested dollars. In addition, our desire is that the program stimulates entrepreneurial activity in the State of Arkansas.

We are very concerned with the SBA's unilateral right to call the outstanding portion of a private investor's commitment to the SBIC and require that it be applied not to new or existing investments, but to outstanding leverage. While we are a public agency, we view ourselves no different than private investors who expect their money (less fees) to be invested in small businesses, not to be used to repay SBA. We understand that SBA has a preferred position with respect to return of capital upon dissolution, but that is much different from an expectation that private capital will never be deployed as investment capital that carries with it a potential for both return and gain.

I would like to discuss with you in further detail the implications of SBA's right to call and what is being done to address the concerns of private investors like us.

Sincerely,

Gene Eagle

Gene Eagle
Vice President for Development Finance

GE/cd

(501) 682-5900 ♦ FAX (501) 682-5939 ♦ www.accessarkansas.org/adfa

Mr. MERCER. That is a significant issue for many private investors, and we think that perhaps through the reauthorization bill Congress could kind of clarify what the intention was.

In a related area, we are working with the SBA to probably suggest a change in the participating security distribution laws. We do not have an exact proposal yet, but I think we are getting closer. What this will do is it will have a positive impact on the subsidy rate. It will allow the SBA to get its money back faster without being a disincentive for private investors to continue the strong support for the participating security program.

Other issues that we hope to discuss with the Committee, as we develop the bill, are the leverage cap. As you know, there is a leverage cap that any one SBIC or group of co-managed SBICs cannot exceed right now under the law, about $112 million in leverage. The SBIC program is a program of smaller venture capital funds, making smaller investments, and we really do not want to change that.

By the way, you might be interested that over 65 percent of money committed to venture capital funds in 2001 went to funds with more than $250 million. The SBIC program is really a small fund program, and we want to keep it that way.

But what is happening is for funds that are on the larger size of the SBIC program and are successful, and if they succeed in getting an additional license from the SBA, because of market conditions liquidity events are being pushed further and further out in their first fund. They are not able to get their money back in the first fund, even though value might be there, and the SBA has supported that by giving them a second license. Therefore they cannot pay leverage down on the first fund and start to draw leverage in the second fund.

I think what we would like to discuss, and we have not even discussed this with the SBA, but thought about it last night, to discuss it as we go forward in reauthorization, is perhaps having the cap as it exists now apply to any one fund, as it does, but to provide a bridge for subsequent funds by saying that no more than $150 million for multiple funds. I just took a third and said maybe we can bridge this so that they will be doing that.

Finally, and I did this in the House testimony, and I think Wayne will be an awfully good person to ask about some of these issues, is one of the values of the SBIC program is that fund managers not only provide money but work very closely with the entrepreneurs that they support. They serve on board seats and they do much more than that. They spend a lot of time working with individual companies.

There is a provision in the law that says that all SBICs must invest 20 percent of their money in smaller funds, smaller businesses, which is a subset of permissible small businesses. For the very large SBICs, and we are talking about probably less than 10 percent or about 10 percent as the SBICs who have been able to raise private capital of say $50 million or more, what that does is it starts to force them to invest in far more portfolio companies than they have personnel to actually go out and work with.

What we would like to discuss, both with the SBA and with the Committee as we go forward in reauthorization, is taking away the

mandatory nature of that statutory clause for SBICs with $50 million or more. I think Wayne would agree with me that once you are forced to invest—you always need a diversified portfolio for safety and soundness rules, and that covered by the overline limits. In other words, SBICs have to have a certain number of portfolio investments. But if you start to make them invest in too many investments, then they lose the ability to work with the entrepreneurs.

I have well exceeded my 5 minutes.

Mr. WARREN. Lee, I think I can say for Senator Snowe that, at least on the UBTI issue, that the message has been delivered, so you are in good shape there.

Wayne, did you want to add anything?

Mr. FOREN. Yes. We have a small SBIC that is a participating security SBIC. We have $15 million in private capital and with that small capital base we are then eligible for the third dollar of leverage, which we are in the process of seeking a forward commitment on.

Our focus is growth stage businesses. $1 million to $3 million is the amount that we invest in a company. We very seldom put in $3 million. It is usually $1.5 million to $2 million, keeping a little dry powder because you always need it.

Our focus, in terms of type of business, is manufacturing, distribution or B-to–B service, business-to-business service. We have 13 to 14 businesses in our portfolio, eight of which are manufacturing.

It is interesting to note, when we think of the LMI area, of our companies, three of them are in enterprise zones and four of them are either minority-owned or minority-managed. I think, without being an LMI-type company, that we are doing what is appropriate. We seek to do businesses whether or not they are in that area. We are not an LMI-type fund, but from time to time we run across pretty good deals in that regard.

With respect to the point Lee was making, having every fund focus on smaller businesses is not a bad idea. When we established that rule in 1993, it was with a purpose. We did not want larger SBICs to forget from which they came.

Now the smaller standard is $6 million in tangible net worth or $2 million in net income after taxes. That is the old SBIC standard. Having said that, it is also important to realize that the management team can only shepherd a certain number of investments.

To the extent that you hold that fast and grow the fund, you are forcing them to have a larger staff. However, to some extent, you are also requiring them to continue to serve that smaller business.

Ms. FORBES. Wayne, can I just do a follow-up on that? Why is it bad for them to have a bigger staff?

Mr. FOREN. There is nothing wrong with having a bigger staff.

Ms. FORBES. That is just a natural flow from having—

Mr. FOREN. As you grow the fund you are going to have a larger staff. I used to think that it would be an easy task for an SBIC person to do five or six deals a year. It is like 504 loans, you ought to be able to do one a month. I have to tell you, it does not work that way.

I would like to reitierate the point that Lee made. When we provide financing to small businesses we do not just give them the money. If we make an equity investment, we always take one board seat, sometimes two, on a five-person board. That other seat would be occupied by an independent director who can add value to the company, either by being an industry person or somebody who is of value.

If we are doing debt deals, of course, we have observation rights. We do not take board seats, but we are actively involved. We like to think that we are knowledgeable, actively involved, add value, but we do not take control unless the company gets off its plan that we have financed.

We have a couple of our companies that have gone sideways to us, and of our four partners, two are acting as CEOs. In one case, we bought back a sub-debt strip that was in a deal for 20 cents on the dollar. But by doing that, and that required an overline investment and we appreciate that. But by doing so, we were able to protect not only our investment but keep the SBA from suffering losses because we could walk away from our total equity investment and recover it all out of the sub-debt strip through collection. It is a traditional business, and it has revenue. But it was just overleveraged, so we will do fine on that bill.

However, Patty, it requires a lot of work.

Ms. FORBES. I could not understand what the downside of having a bigger staff would be. It seems to be part of your point, too, and frankly, it sounds like an argument on why you should not have bigger funds if they cannot handle more than 20 to 30 deals.

Ron, do you have a view on that?

Mr. MERCER. Essentially, to run a venture capital fund, I mean people try to run them in the most efficient manner. In other words, deploy the capital in a way where you have mitigated as much risk as you can but without spreading yourself too thin, because management fees are capped at some level. Actually there is a pressure on reducing management fees across the industry.

At some point, you cannot keep expanding. It just does not work.

Ms. FORBES. But are not management fees a percentage of the total funds?

Mr. MERCER. Right.

Ms. FORBES. So if it is bigger, there would be more fees?

Mr. MERCER. There is only so much time that these are highly paid individuals. At some point it starts to break down.

Ms. FORBES. Does Ron have a view on this?

Mr. BEW. I think one of the 5 problems the industry is having is the average size of the investment was probably $1 million last year, and it has now dropped to close to $500,000. So it is meaning more investments going up. But it would appear that 2.5 percent is the cap the fees would allow for.

Mr. MERCER. That is the maximum allowable.

Mr. FOREN. 2.5 percent of combined capital which is leveraged on private capital.

Mr. MERCER. But private limited partners, as I am sure Wayne would attest, are starting to revolt at 2.5 percent, because most private limited partners are trying to get managers to accept less.

Mr. FOREN. But it is a balance. The limited partners give you a reality check. They are watching. We have got great limited partners. They want to make sure that you are properly managing the fund, so that you get enough resources to effectively manage it. When you have deals that go sideways on you, make sure that you do not just walk away from them but handle them right, and that takes time.

We have not had pressure with respect to the management fee. What our limited partners want to know is what are you doing with the deals? Are you acting responsibly to get the money back and to grow the fund? They have not questioned the management fee, at least ours have not.

Mr. WARREN. Wayne, can I go back for just a second to something you mentioned earlier on in terms of the LMI work that you have done? Following up on the theme of a question that Senator Snowe asked earlier, is there an overlap between the SBIC program and the New Markets Venture Capital Program?

Mr. FOREN. SBICs ought to be doing deals that deserve to be done, whether new markets or otherwise. SBICs, in my opinion, ought not to say, because we have a new markets initiative, we do not have to focus or do not have to give consideration to that market area.

Going back to the 1970s, the specialized SBIC program started in 1972 as an initiative before there was a legislative initiative to provide financing to a specific area, those who were socially or economically disadvantaged. Out of that grew the specialized SBIC program, and it served a purpose.

If you would like to emphasize a given area, then proceed with your LMI initiative. If you want to have the mainstream program provide assistance to that area, then encourage and give incentives to do so.

Our fund, we have committed to our limiteds to put money to work where we have raised it. For example, we have raised part of our fund in Puerto Rico. I believe that we are one of few SBICs that have done deals in Puerto Rico. It is because we have raised money down there.

There are some good deals down there, but just like any other area you have to be careful what you do. I believe there are good deals in the LMI area. If you are going to have a fund, you have to propose that you are going to give those deals consideration. Again, if you want to have a special emphasis program, then obviously you are going to get more attention to that special emphasis area.

However, you're spreading the risk. If you have the SBICs do some assistance in that area, then you are spreading the risk and you are not having it focused in a specifically targeted area.

Mr. TESDELL. My name is Kerwin Tesdell.

I would agree with that and think that the SBIC program, which is very important, has a different focus. It is getting equity capital into smaller businesses. The specialized program, the New Markets Venture Capital Program, has a different focus which is getting equity capital into lower income communities.

You had asked about lessons learned. I think one lesson my organization has learned is that this is a specialized activity that know-

ing how to do developmental venture capital in these areas is a different kind of thing from—many of the tools are similar. But what Blake and the folks at CEI do is a different practice from traditional venture capital and you need specialized funds that know how to do that. Also, you need a program that provides appropriate resources. We can address that, I guess, in a few minutes.

[The prepared statement of Mr. Tesdell follows:]

**Comments by Kerwin Tesdell, President**
**Community Development Venture Capital Alliance**

**Before**
**Small Business Committee**
**United States Senate**

**Roundtable on Small Business Administration Credit Programs**
**May 1, 2003**

**Introduction**
Chairwoman Snowe, Ranking Member Kerry, and members of the Small Business Committee, thank you for this opportunity to participate today in a roundtable discussion about the various credit programs administered by the Small Business Administration, and in particular provide you with my comments on the New Markets Venture capital Program. My name is Kerwin Tesdell and I am President of the Community Development Venture Capital Alliance - the national trade association for the community development venture capital industry.

Community development venture capital funds are mission-driven venture capital funds. They provide patient equity capital and business management expertise to small but growing businesses that promise both financial returns for their investors and social returns to low-income people and distressed regions in which they invest. This double-bottom line distinguishes CDVC from traditional VC funds as well as from Small Business Investment Companies (SBICs).

Six of the seven companies selected to operate a New Markets Venture Capital Company are members of my organization and CDVCA was a leading advocate in working with Members of this committee to enact the New Markets Venture Capital Program in 2000.

I am here to urge this Committee to re-authorize the New Markets Venture Capital Program. Congress enacted the New Markets Venture Capital Program for three reasons: 1. Many low-wealth towns and cities across the country missed out on the infusion of equity capital and business wealth generated during the nineties economic boom; 2. 98% of traditional venture capital is invested in metropolitan counties, the majority of which are along the two coasts; and, 3. SBA does not operate a similar program targeted to equity investing in low-income communities: the majority of investments made by SBICs are made in middle to upper income communities.

**The New Markets Venture Capital Program is proving successful**
The New Markets Venture Capital Program is proving to be a complete success: all seven conditionally approved NMVC funds raised the required capital match, over $70 million, within the time frame established by the SBA and by Congress. They did so in one of the most difficult fundraising environments the venture capital industry has ever faced. In the year 2000, the venture capital industry raised $106 billion in new capital, and in 2001 it raised only $26 billion. However, in 2002--the year in which the primary fundraising for the new NMVC companies occurred--the venture capital industry was able to raise only $6 billion. In the economic

environment in which these funds were operating, their ability to raise their full requirement for a private capital match for funds operating in some of the most economically distressed parts of our nation was truly extraordinary.

Raising the capital in this economic climate was not easy and it indicates that there is an appetite and need for this type of investment capital. Due to the NMVC program, we can expect to see investments of up to $175 million to promote small business development in low-income communities throughout the east coast and in parts of the southwest and up to 12,000 jobs created.

The program has also attracted investment partners from a variety of sectors. Banks contributed 31 percent and state and local governments contributed 29 percent of the total investment capital raised by the NMVC Companies. Utilities and insurance companies contributed 6 percent, foundations contributed 10 percent and universities contributed 7 percent. Angel investors contributed 6 percent and other corporate givers provided approximately 3 percent of the total capital raised. Non-profit parent organizations of the NMVC Companies contributed 8 percent of the capital and the remaining investments were contributed by various other non-profit organizations. Total private non-government, non-charitable contributions is 46 percent.

**NMVC: A Unique Program**

The NMVC occupies a unique niche and purpose in promoting investments in small businesses in poor communities. The New Markets Venture Capital Program provides guaranteed financing to help capitalize venture capital funds and grant financing to provide operational assistance to portfolio companies. Congress passed the New Markets Venture Capital Program as part of the Consolidated Appropriations Act of 2001 (P.L. 106-554) and appropriated $22 million as subsidy for debenture guarantees and $30 million in grant financing to support up to fifteen NMVC Companies. These monies were enough to provide up to $300 million in investment capital to small businesses in low-income areas. Half of this money has been obligated to support seven NMVC Companies. Congress unexpectedly rescinded the remaining monies - $24 million - in the 2003 Omnibus Appropriations Bill and I urge this Committee to seek replacement of these funds as soon as possible.

The New Market program was part of a larger bipartisan initiative to target federal assistance to improve local economies in low-income urban and rural communities. The other elements, included in the Community Renewal Tax Relief Act, were the New Markets Tax Credits, additional empowerment zones and a new program -- Community Renewal Zones. The idea was to try a number of different approaches to alleviate poverty to better understand what works the best. With the exception of NMVC, all the other programs are going forward. We believe there is great potential in the NMVC approach and hope Congress will act to get the second round funded and underway.

The New Market Venture Capital economic development initiative is modeled after the SBA's other successful venture capital program called the Small Business Investment Companies program. However, New Markets Venture Capital targets its investments to development of high-growth small businesses in our country's poorest urban and rural areas, and ties investments to the creation of local jobs with livable wages and benefits for individuals who historically have

no opportunities for employment or who are the working poor. The hardest jobs to create are those in desolate rural areas, and yet three of the top community development venture funds have a record of doing it for $15,000 a job, versus other programs, such as the SBIC program, that cost anywhere from $35,000 and more to create a job.

There are two key elements to the NMVC Program that distinguishes it from conventional equity funds and from other SBA programs:

Targeting: The New Markets Venture Capital Program is the only federal program targeted specifically toward leveraging developmental venture capital for investments in small businesses located in low-income areas. Patient capital that equity investments provide to businesses is crucial for spurring economic development activity in low-income areas because this type of investment does not require immediate pay back by the small business.

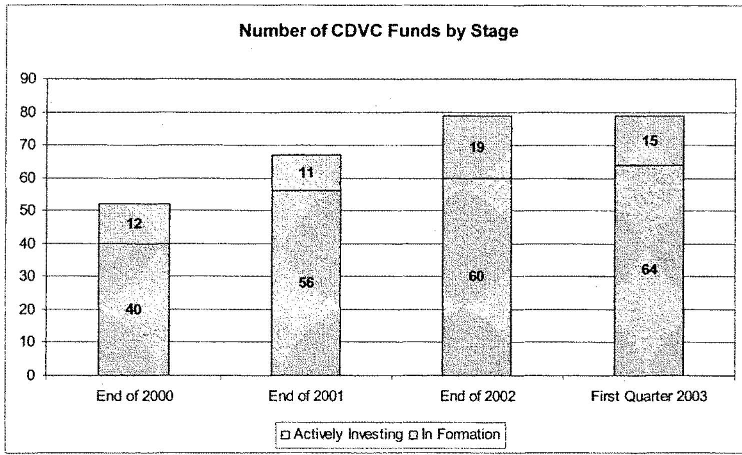
Operational assistance: The NMVC program builds into it grants for operational assistance so that fund managers can work with portfolio companies to help ensure their success. Providing operational assistance to entrepreneurs in low-income communities is an essential aspect of the work of community development venture capital firms because it allows us to make investments in communities not served by conventional investors. CDVCs recognize that the entrepreneurs in whom we invest may struggle with developing a viable business plan, managing employees or aggressively marketing their products and services. However, the entrepreneurs most willing to operate a business in low-income communities are often likely to come from the community. By working with these individuals and providing some "how-to" guidance, the business is more likely to remain a viable business.

We expect six of the seven conditionally approved New Markets Venture Capital Funds to be fully operationally this month. One fund, Adena Ventures based in Athens, Ohio, began investing last year and has already invested $1.6 million in three early-stage companies and provided operational assistance to sixteen.

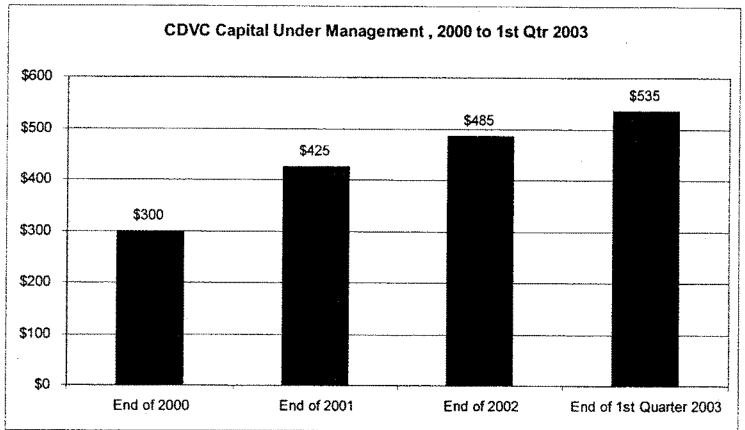
The three companies in which Adena has invested are located in West Virginia and include two software companies and one healthcare plan provider: Butterfly.net, Inc is a Martinsburg, WV based software development company that provides a unique grid infrastructure for multi-layered online games; SecureMethods, Inc. is also based in Martinsburg and is a security software company that specializes in the design, implementation and deployment of advanced secure network applications for commercial, healthcare and government clients; and, Vested Health, LLC is a Charleston, WV based provider of consumer directed health plans for employer groups with 10-2,000 employees. Together with fourteen additional central Appalachian companies that have received operational assistance, Adena's funding has helped create, maintain and enhance employment prospects for more than 200 individuals.

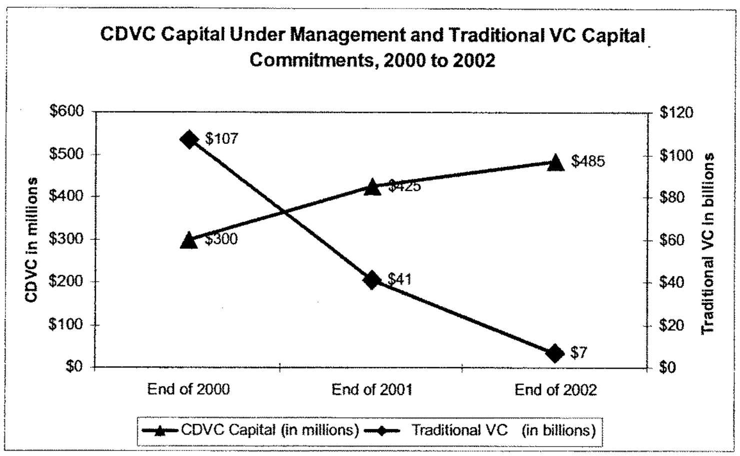
**Current CDVC Industry Profile**
As of the end of the first quarter 2003, the Community Development Venture Capital Alliance counted 79 community development venture capital funds, 64 actively investing and 15 funds in

formation. The 64 funds actively investing include the four NMVC companies that had closed by the end of March 2003.




CDVC capital under management has grown substantially over the past few years from about $300 million at the end of 2000 to $535 million by the end of the first quarter 2003. What's more, this increase in capital under management occurred during a period of substantial contraction in the traditional VC arena. New capital commitments for traditional VC funds plummeted 93 percent from 2000 to 2002, according to numbers compiled by the National Venture Capital Association, the national trade association for traditional VC firms.




CDVC funds pursue a variety of social goals: creating good jobs for low-income persons, growing wealth for new entrepreneurs and the employees of their companies, expanding the entrepreneurial capacity in low-income areas, and providing products and services to distressed regions and neighborhoods, to name a few. Based on research conducted over the past three years, CDVCA has found that CDVC funds have excelled at creating good jobs for low-income persons. Based on analysis of our 2002 survey, we found that CDVCA member funds create one

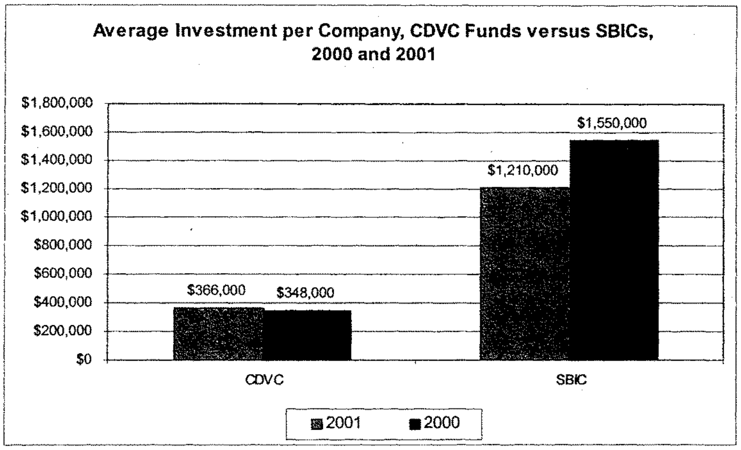
job for every $15,000 of invested. And about 65 percent of these jobs went to low-income persons.

**SBIC Investment Activities Do Not Substitute for CDVC Investment Activities**
As noted earlier, CDVC funds are double-bottom line venture capital funds. This double bottom line approach marks the fundamental difference between CDVC funds and Small Business Investment Companies (SBICs). The difference manifests itself in several ways.

First, CDVC funds and SBICs tend to invest in different areas. For example, SBIC investments are highly concentrated in the same states where traditional VC funds are most active. According to statistics compiled by the Small Business Administration, between 1998 and 2002 50 percent of SBIC investments went to just five states--California, New York, Texas, Massachusetts, and Illinois. By contrast, CDVC funds are most active in places not usually associated with venture capital such as Appalachia, the Mississippi Delta, the Cascadia Mountains of Washington, rural Minnesota, and eastern Kentucky. And the CDVC funds that are active in the five states where traditional and SBIC funds are concentrated tend to invest in the neighborhoods and communities that, again, are not typically associated with venture capital: East Palo Alto in California, Harlem, Dallas' Southside, the Roxbury neighborhood in Boston, and the Southside of Chicago.

A second significant difference is market focus including investment size and industry focus. CDVC investments averaged about $350,000 per company in 2000 and 2001, while SBICs' average investment size over those two years was about $1.4 million. The difference in investment shows that CDVC funds and SBICs are meeting different market needs in the same way that SBICs and traditional VC firms, with an average investment size of over $10 million per company, are also active in different markets.

In 2002, SBICs primary industry focus was high technology and accounted for 41 percent of all financings. The manufacturing sector received just 28 percent of all SBIC dollars invested in 2002. By contrast, CDVC funds have a much stronger focus on manufacturing, which accounts for 50 percent of all CDVC portfolio companies.




Finally, CDVC funds provide tremendous amounts of technical assistance to their portfolio companies. This one-on-one assistance includes sitting on portfolio company boards, helping to expand their markets, arranging follow-on financing with new investors, working to fill holes in the management team, to name just a few of the activities that fund managers undertake as partners in their portfolio companies. CDVCA's 2002 Survey of the Industry found that CDVC funds provided an average of 73 hours of TA to each of their portfolio companies. But the number fails to convey the significance that TA has on growing companies. Business management expertise is fundamental to venture capital investing; it is especially significant for the portfolio companies in which CDVC funds invest, since, in so many instances, the entrepreneurs have had little or no experience with equity investing and few entrepreneurial role models from whom they might learn. In fact, many entrepreneurs that work with CDVC funds conclude that the TA was as important to their success as the money.

All of this is to say that CDVC funds and the NMVC companies provide *developmental* venture capital. The purpose of which is to generate positive financial and social returns using the tools of venture capital.

The purpose of these comparisons is not to suggest that the SBIC program is in any way flawed. Small Business Investment Companies have a different public policy goal and have had tremendous success achieving that goal. Indeed, it the successes of the SBIC program that CDVC funds in general and NMVC companies in particular hope to repeat in places where equity capital is in the shortest supply and where business management expertise is most needed.

**The New Markets Tax Credit and the New Markets Venture Capital Program**

The New Markets Tax Credit and the New Markets Venture Capital programs were designed to work together – the New Markets Tax Credit was intended to be a tool to help the New Market Venture Capital Company raise the private investment capital. Unfortunately making these programs work together has not been easy and I urge this Committee to support changes in the law that would make these programs work better together and to urge the SBA to better coordinate with the Department of Treasury.

The following is a list of key areas in which these programs diverge:
1. Special CDE Status: In order to apply for an allocation of a NMTC, an organization must receive certification as a Community Development Entity. The New Markets Tax Credit statute grants automatic CDE status to SSBICs and to Community Development Financial Institutions (or CDFIs). New Markets Venture Capital Companies should also receive this special status. Special status would eliminate one extra application process that we must submit and it would encourage more NMVCs to use the NMTC program.

2. Metropolitan census tract definitions are different under both programs: Targeted investment census tracts in metropolitan areas are also defined differently: Under the NMVC program, investments are limited to census tracts where the poverty rate is 20% or more, or if the census tract is within a metropolitan area, where 50% or more of the households have an income of 60% of the area median income; Empowerment Zones and Communities and HUBZones automatically qualify. Under the NMTC program, a census tract qualifies if it contains at least 20% poverty rate or if median household income is up to 80% of the area or statewide median. We urge this Committee to conform the definition of a qualifying metropolitan census tract under the NMVC program to that under the NMTC program.

3. Administrative measures: I urge this Committee to work with the SBA to urge them to better coordinate with the Department of Treasury on the implementation of the NMVC and NMTC program. The Department of Treasury, on its own, granted a 'look back' whereby investments made to qualified entities prior to the date credit allocation decisions were announced but after April 2001 could still receive a tax credit as long as requirements under the NMTC program were otherwise met. This allows taxpayers making investments in a NMVC Company after July 2001 the ability to use the credit, even though credit allocations were made at a later date. The Department of Treasury did this voluntarily and demonstrated a willingness to be as flexible as the legislation allows them to be to accommodate the NMVC Companies. We urge the SBA to also identify ways in which the administration of the NMVC program can be better coordinated with the NMTC program.

**Recommendations for Re-authorization:**
CDVCA strongly urges Congress to re-authorize the New Markets Venture Capital Program for several reasons: one, it's the only federal investment program designed to provide venture capital financing to low-income areas; second, it is also the only venture capital program that provides operational assistance to companies in which investments are made; and third, it works: All seven of the conditionally approved NMVC Companies are on track to win final approval from the SBA by July 9th and over a dozen small businesses are already receiving the benefits of the program.

We also strongly urge the Committee to work with Appropriators to restore the $24 million in rescinded funds so that SBA can move forward on a second round of funding as soon as possible. Several organizations across the country were gearing up to apply for a second round of funding when these monies were rescinded.

Raising the capital in this economic climate was not easy and it indicates that there is an appetite and need for this type of investment capital. In fact, due to the NMVC program, we can expect to see investments of up to $175 million to promote small business development in low-income communities throughout the east coast and in parts of the southwest and up to 12,000 jobs created.

We do offer some recommendations for strengthening the program:
1. Debenture rate: limiting the interest rate charged on the debenture to a fixed rate of 4% or less would enable the investments to target higher risk sectors, such as manufacturing, and still ensure an adequate return to investors.

2. Definition of equity capital: allow subordinated debt with some amortization features to qualify as an equity capital investment. The current definition used by the statute is the same definition used by the SBIC participating security program, which is a different investment instrument than the debenture. Unlike a participating security, the debenture requires repayment according to a pre-established schedule rather than according to company profits.

3. Operational assistance: Allow conditionally approved NMVC Companies to receive some early grant assistance up to $100,000 at the point of initial designation so that they can cover out of pocket expenses necessary to establish the fund. If the Companies fail to win final approval, the grant would be repaid to the SBA. In addition, we urge the Committee to work with SBA to administer the operational assistance grant program in a way that provides broad and flexible services to the companies receiving assistance.

4. Metropolitan census tract: Adjust the definition of a metropolitan census tract to conform to that contained in the NMTC program.

**Conclusion:**
Congress passed the New Markets Venture Capital Program in December 2000 because it recognized that many poor communities do not have the ability to generate private wealth sufficient to grow a small business community. It also recognized that equity capital - patient capital that doesn't require an immediate pay-back – is critical to many small businesses. These two points are as true today as they were in 2000 – perhaps more so given the current economy.

We urge you to restore the funding appropriated for a second round of NMVC financing and to reauthorize this important developmental capital investment program.

Mr. WARREN. Actually, this whole topic covers both SBIC and New Markets Venture Capital, so feel free to jump in.

Mr. BROWN. Blake Brown, Chief Financial Office at Coastal Enterprises.

We are a sponsoring organization of a New Markets Venture Capital fund, CEI Community Ventures, Inc. We just closed our fund last month after a fairly lengthy effort. But we are really excited about the program.

Also, to address some of the concerns that Wayne had brought up, I think this program really has been crafted and structured to address some of the management issues of a fund by providing some matching technical assistance funding that goes along with the financing piece. I think that is a critical distinction between SBIC's and the New Markets Venture Capital companies, in order to provide that service to the small business.

I think the critical piece here, is making sure that they get that hands-on experience and help. As Wayne said, it is hard to manage a fund with a lot of deals in it. It is a very labor-intensive business, venture capital is.

I am on the board of both of our venture funds and we have very talented and qualified staff who go the extra mile, but they need that additional help. Part of the program, under the way it is set up under New Markets Venture Capital, is to allow us to be able to set up a mechanism whereby we can develop an appropriate range of outside expertise that can be brought in to assist the companies that we are investing in.

Again, that is a critical component to this, to our effort, and we think that that is what is really going to make the difference between failure and success in terms of the businesses that we are supporting.

We have had Venture Capital experience that goes back to mid-1980s. We started our first formal venture fund in 1997 with $5.5 million and have been able to invest that fully and are starting to generate some reasonable returns from that fund. So small funds can be managed. It does not have to be a $30, $40, $50 million fund. I think the average size of our investments has been between $100,000 and $300,000, which is what the New Markets Venture Capital program is targeted to.

It is interesting that under the SBIC program they have gone from $1 million down to $500,000. It is still above the target market that we are looking for in our venture funds.

I think the other distinction is the fact that we are focused on underserved low income communities. Those are areas that need directed capital, and support. It cannot be just kind of an offshoot of a larger program. I think it takes that concerted effort to make things happen in those communities.

That is why we are really excited to have this fund. We are one of six that, I believe, have closed and have received funding. We are a little bit concerned that funds have not been authorized going forward for this.

We think there is a lot to be learned with this program. We are really excited about it.

I would just cite an example of the deal that we did through our first fund. It is basically a company that is called Maine Coast Or-

ganic Products in Washington County, Maine, which has an average wage of $12,500. It is a very low income county. We have invested a little over $100,000 in this particular company that converts waste product, from fisheries to blueberry barrens, into what we call designer dirt, or compost. I think you can actually buy it here in Washington, D.C. But it is a company that would not have come up on the radar screen.

Mr. BEW. Does it come with black flies?

Mr. BROWN. Depends on the season.

I think this probably would not have come up on the radar in an SBIC-type of situation and would not have attracted traditional equity. We think there are a lot of those opportunities that are being missed because venture capitalists have got their radar set a little bit too high.

Again, I think the SBA can play a big role here in promoting that kind of activity. Those are my comments.

Mr. TESDELL. Maybe I can just add a little bit. I am the President of a community development venture capital alliance, the Association of Community Development Venture Capital Funds.

As you know, we are sort of the new guy on the block, a new program. I think I can report that at least so far the program has been a tremendous success. There were seven conditionally approved New Markets Venture Capital companies and, at this point, all of them—while they have not all completed the full process with the SBA—all of them have raised their private sector match. That is $70 million that is going into lower income areas. This is money raised from investors, many of which are not traditional venture capital investors. It is coming from colleges and universities, from foundations, from local governments, and from local corporations, all interested in supporting the development of their communities.

This is a really remarkable success, given what is happening in the rest of the Venture Capital field where capital raising has come to a standstill. We had a situation where we had a new Government program, and our sales pitch was: give us money to invest in some of the most disinvested areas of the country. Yet, these companies have been successful. I think that is remarkable.

Again, just to emphasize some of what Blake was saying about the differences between new markets and some of the other programs that the SBA operates, first of all, we are targeted. We are specialized companies. The kind of expertise that organizations like Coastal Enterprises and others around the country develop in doing this developmental venture capital activity is really necessary in doing the kind of work that we do.

Also, this sort of flows directly from your discussion, the issue of the program providing this technical assistance money to help pay for the extra assistance that our funds provide to smaller companies run by people who do not have Harvard MBAs and experience at Intel and so forth. That is the key portion of this program that allows New Markets Venture Capital companies to play this developmental venture capital role.

I want to emphasize that this is not a program that was invented in Washington, that there is an entire industry out there of funds that do this sort of thing. We count 79 community development

venture capital funds and funds in formation around the country, with more than $500 million under management.

Again, differences from the SBIC program. While 50 percent of the money of the investments from SBICs recently have gone to five high wealth states—California, New York, Texas, Massachusetts, and Illinois—community development venture capital fund focus on places like Appalachian, Kentucky and the Delta region of Mississippi, and northeastern Minnesota areas, that traditionally have been disinvested and where rates of unemployment are very high.

We also mentioned investment sizes. The average investment size for a community development venture capital fund is $350,000, as compared with the numbers you were just hearing.

Through SBICs over the last few years, about 41 percent of the financing has gone to higher tech companies. For community development venture capital funds, fully half of our investments have gone into manufacturing companies, the types that provide good jobs for lower income people.

Just to sum up, I think Congress originally authorized and created this program because it saw a need to bring equity capital and the power that that tool has brought through the SBIC program and other venture capital funds to the Nation and focus that on areas of the country that need it most. That was in December 2000. If you look at the economic situation right now, the program is even more needed.

We are asking that this program be reauthorized and also we are hoping that the appropriations will continue to this program.

Mr. FOREN. Just an observation. I would expect that your investors, your limited partners, would require a lower rate of return. Is that true?

Mr. BROWN. No, not necessarily. Again, our philosophy has always been what we talk about as two bottom lines, and we added a third. We really are conscious about what we invest in with respect to the environment, but also we are looking for the social mission and the financial return. We do have some banks that are investing in our funds.

I think they are looking for a reasonable rate of return. Venture capital returns are all over the ballpark, we know that. But the whole point is that we are here to try to make money, but also to have social impact.

Mr. FOREN. But I would think the thesis would be, because you did have the public purpose focus, that your investors would have a greater tolerance for a lower rate of return, as opposed to venture funds that limiteds are putting money into with the expectation of getting a higher rate of return.

Mr. BROWN. Again, some of our investors may have that philosophy, but our approach has always been that we are here to make money but also to provide the social impact and to test that thesis, that you can make money and be socially oriented.

Mr. TESDELL. If I can add, I think those two things tend to go together. You can have a successful business that creates profits for your fund, but that also creates jobs and is a sustainable business.

Mr. WARREN. Wayne, can I ask for your comments, in terms of how is technical assistance handled when your SBICs make investments in LMI businesses?

Mr. FOREN. We do not, when we make an investment we are looking at where this company is going. Our focus is growth stage companies. We are looking for a growth plan. The business plan we expect to show growth.

Frequently, the only thing we would do is, which is a little different, is that we typically have a management consulting arrangement with them, established right at the outset, whereby if we have to put a lot of time unexpected into that company, we expect to get paid for it because we have limited resources. But that is not giving technical assistance where they are getting it for free or on the cheap. That is where they are paying us, getting back to this point of having limited fees income.

When we make an investment, it is a determination that we believe in the business proposition, in the plan, the concept, and we are there to do what we can to help grow that company. So whatever we give, we give. But there is no concept of funding that "technical assistance".

Mr. WARREN. Lee, I know you have been patiently waiting.

Mr. MERCER. I do not want this to be a battle of statistics, but since you opened the door, last year $737 million of SBIC money was invested—that is 28 percent of all money—was invested in 434 manufacturing companies in 41 States. So I do not want it left on the table that somehow this program is some high-tech program for rich kids.

Secondly, of all the money invested last year by SBICs, 27 or 28 percent of it, again over $700 million, was invested in companies located in LMI areas. My understanding actually, in talking to some people at the SBA, is it may be closer to 45 or 50 percent of the money, depending on the definition.

So NASBIC has remained neutral, and has never taken a position on the New Markets Venture Capital Program. We do not profess, as an organization, to have expertise to say whether or not the targeted program is necessary. All we can show is what we do, and our members, like Wayne, invest in small businesses that show the potential for growth, wherever they are, and whatever the industries they are in.

Thank you.

Mr. WARREN. Ron, did you want to add to that?

Mr. BEW. I can follow up on that. Lee makes an interesting point. Those numbers are pretty close to correct. It is interesting to note that the market is serving with great impact the LI and LMI areas. The LI area, I do not think you quoted that number, since I have them all in my head, was $1.2 million.

Mr. MERCER. I did not know there was an LI area.

Mr. BEW. We looked at the LI impact and it is around 25, almost 26 percent, $725 million. I think the New Markets Capital Ventures Program was more akin to an LI area. The SBIC program actually, stunningly, went up to 46 percent by dollar and $1.2 billion. That is the market serving these areas.

Mr. TESDELL. I obviously did not, at all, mean to imply that the SBIC program was not doing important things in low income areas.

In fact, this whole tool of using venture capital equity tools to promote growth is something that we certainly believe in.

I guess the question is whether there is a place within the SBA and within the federal programs for a program that can specifically target these areas and that can provide the kind of resources and support needed for funds like Blake's that very specifically target these areas and develop that kind of expertise.

Ms. FORBES. We have some questions about the SBA's processing of these proposals. Evidently, you got through the process of conditionally approving NMUC's just fine. But then there seemed to be a number of holdups in the closing process. I am wondering, as you are going forward, do you know how many of the seven conditionally approved NMUC's have actually closed?

Mr. BEW. I think five have actually closed. Is that correct? Jeff Pierson is here and can add some of the details. Five of the seven have closed. We extended the program to July 9th. I also think we expect the other two to close. Am I mischaracterizing that?

Ms. FORBES. Is that correct?

Mr. PIERSON. That is correct.

Ms. FORBES. Right now the money has been rescinded for the second round, but if we were successful in getting that restored, would you be prepared to continue work on this program?

Mr. BEW. To do what?

Ms. FORBES. To propose another round of funding and do the conditional approvals. We have a lot of concern that SBA seemed to be dragging its feet on this program. It was a new program and did not seem to be given the proper attention. So we are just wondering, as the money comes to you, the next time there is a supplemental for example, you will be prepared to move forward on the next step?

Mr. BEW. Of course, I was not here back then, but the SBA, the Investment Division area is running the program. The market is difficult and this program has gone on for close to 3 years. There has been difficulty. These five to seven New Market Venture Capital funds have had difficulty, just getting support in the marketplace and investments.

Ms. FORBES. But there have been significant delays in the processing at the SBA. My question is really going forward, will you be prepared? Is the New Markets Office going to continue, up and running, so that when the SBA gets this money restored, you are going to be prepared to act on it? Or are you going to have to reconstitute an office or add people?

Mr. BEW. We are running the program now.

Ms. FORBES. Your intention is to keep the office open? The separate office for New Markets Venture Capital?

Mr. BEW. We will continue to operate the program. We have people dedicated to the program, yes.

Ms. FORBES. We will have some follow-up questions on how many people are staffing that, et cetera. Because we do not want to re-create another delay.

Mr. BEW. It takes some resources, because it is not just funding or licensing going through competitive bidding. It is also an oversight issue. So it will take some resources to manage the fund.

Ms. FORBES. You are continuing to do that?

Mr. BEW. We are.

Ms. FORBES. Great.

Mr. WARREN. Are there any other comments on the SBIC and New Markets Venture Capital area?

Ms. FORBES. I actually have some questions for Lee. You are recommending that the percentage go up to 1.5 percent?

Mr. MERCER. Correct.

Ms. FORBES. Are you confident that that will be okay for a 3-year reauthorization period? Or is there some way that we should allow for adjustments in year two and three of the 3-year reauthorization?

Mr. MERCER. Well, the suggested 1.5 has no magic in it. If the number that were put in were higher than that, I think it probably would leave more room for variations over a 3-year period so we would not have to come back in.

There is really no, right now, existing sensitivity analysis that I can point you to that says at X percent it becomes a disincentive for people to invest in SBICs.

But clearly, and I think some in the SBA have suggested—well, the SBA, I believe, has suggested 1.7 percent, am I correct? We would not have any quarrel with that.

Ms. FORBES. Ron, what is that based on, the 1.7?

Mr. BEW. It is just the allowance going forward.

Mr. MERCER. It is the fudge factor.

Ms. FORBES. It would be up to 1.7 percent? Right?

Mr. MERCER. It is a floating percentage.

Ms. FORBES. You would only place it at whatever it takes to get to the zero subsidy rate?

Mr. MERCER. Right. Our hope is that actually when we come to the Committee with—when the SBA and the industry come, hopefully within the next 30 days, with a proposal to change the law on participating security distributions and how they are characterized, that that is going to have a positive impact on the subsidy rate so that not to exceed 1.5 or not to exceed 1.7 would hopefully trend down. Unless OMB makes some serious errors in their assumptions.

Ms. FORBES. You will have some sort of projection about the effect on the subsidy rate that the new proposal is likely to have?

Mr. MERCER. As I understand it, the SBA right now is trying to—and I do not want to put words in their mouths. NASBIC has suggested one potential change in the law. What we have asked is whether the SBA could determine if the law were to change that way, say for this year, if it had been changed this year what would the subsidy rate have been. So that we can get a feeling for what the impact would be.

That is what the SBA is working on now, and we are hopeful that that will bear fruit in the next 30 days.

Mr. WARREN. Lee, we would obviously like to continue working with you on that package, as well. I now you and Greg and others have discussed it and we are wide open for that.

Mr. MERCER. I just do not want to lay anything on the table yet because we are uncertain as to—A, we want to be in agreement with the SBA, if it is at all possible. We do not want to lay anything on the table until we try to understand exactly what the im-

pact will be. We know it will have a good impact. We just do not know how much.

Ms. FORBES. And there is no cross subsidization? Sometimes in the subsidy rate calculations, when one thing goes up, and the other thing goes down.

Mr. MERCER. There certainly is the potential, that is why I mentioned OMB. There certainly is the potential for OMB to readdress some of the assumptions that are in the model that are unrelated to what we are suggesting. Those could have a negative impact on the subsidy rate. The two could end up either balancing each other out or one having more impact than the other.

Ms. FORBES. I have one last question for Kerwin. Do you have a sense of the demand for the second round of funding? If this were reauthorized, do you have any sense of what the demand would be be for the third round of funding?

Mr. TESDELL. Right. Among our membership, already, there are six or seven funds that have expressed very strong interest or had plans to apply for the second round. We expect a much higher demand than that for the third round.

I think, to the extent that we are seeing people holding back, it is because of the uncertainty of what is going on with the program. But once that uncertainty is clarified, I think there will be very strong demand.

Mr. WARREN. Thank you very much. I think this has been very helpful. We have had a lot of good positive feedback and some excellent suggestions on all of the programs we have covered today.

We are coming towards the end of our phase of collecting feedback on programs, looking for recommendations. We have a little bit more work to do in that area, and then obviously then the Committee is going to turn to preparing the reauthorization legislation, which it is certainly our hope to have a 3-year bill as we move forward into the summertime.

We know time is of the essence, and we are keeping that in mind. So we will obviously be calling on you.

As we have done with the prior roundtables, the record will remain open for 2 weeks. If there are additional comments or suggestions that occurred to you that there was not an opportunity for, please, if you would, send them in. One of the easiest ways to do it is if you will e-mail them in to our hearings clerk, Lindsey Ledwin, or to any of us and we will get them into the record that way.

With that, I thank you, and we will be adjourned.

[Whereupon, at 11:30 a.m., the roundtable was adjourned.]

# APPENDIX MATERIAL SUBMITTED

**Submitted Testimony of**
**Ron Bew, ADA Capital Access**
**US Small Business Administration**
**On the 504 and SBIC programs**
**Committee Small Business and Entrepreneurship**

I am proud to be here and discuss reauthorization of the Capital Access programs for the Small Business Administration. I believe that the SBA is in a unique position to serve the American public and increase small business growth and employment. By working for the interests of small business, we serve the country as a whole.

Working on behalf of small business is a non-partisan issue. Both Democrats and Republicans know the impact of small business on our nation's economy. My role in overseeing the Office of Capital Access is to help expand economic opportunities for all Americans. For some that means granting the dream of starting a new business and for many it means creating jobs to feed families and contribute to a growing economy.

Our Fiscal Year 2004 budget requests authority for several programs that require no subsidy budget appropriations but nevertheless require an extension of their authorization. Both our Small Business Investment Company (SBIC) and Section 504 lending program (504) provide a proven impact on the economy and the programs are self-financing, they operate without the need for loan subsidy appropriations. Our SBIC program in 2002 facilitated the investment of over \$2.6 billion, 30% of which went to start-ups.

In the last year these two programs achieved excellent results in the job creation arena. The 504 program accounted for 116,000 jobs and the SBIC program accounted for 78,000 jobs.

In FY 2004 SBA is requesting authority for \$4.5 billion in loans under the 504 program. Currently we are 20% ahead of our 2003 goal. While we may not reach the full capacity of \$4.5 billion we believe the program should have the room to expand.

SBA is committed to the success of the 504 program – so much so that we have nicknamed 2003 the "Year of the 504". We are proud of the industry's impact on small business financing, and believe this program can do even better things for the economy. The SBA is seeking to make some critical changes to allow for greater choices for the small business people looking for fixed rate financing.

On March 6th, the SBA closed the comment period for a Notice of Proposed Rulemaking for the 504 program. Our goal is to strengthen and streamline the program to increase its value to the small business community. We received over 1,900 comments about the value of the program to small business and valuable insights from CDCs and other program participants on how to make changes to increase access to small business

lending through 504. We are currently considering those suggestions and how to incorporate them into the upcoming rule.

In addition to regulatory changes, we are focused on making procedural changes through our workforce transformation. We want to streamline the lending process, where we believe the result of our centralization will have a profound effect on interaction with our agency. Our goal is to provide consistency with that process and a streamlined approach.

We realize we're in the beginning phase of transformation and we've a long way to go. These changes are necessary to allow for quicker decision making and an increased standard of quality. We believe we have already seen improvement in loan processing through our centralization pilot and hope to apply the lessons learned nationwide.

Our agency is also moving forward on addressing the 504 subsidy model. Currently, SBA is in the early stages and anticipates a new model that will be applicable to the FY2005 budget.

Finally, we are requesting a six year rather than a three year authorization period. This proposal is indicative of our confidence in the 504 program and its mission. It will also, we believe relieve the stress that seems to occur every three years as the program reaches the end of its authorization. We believe this request in no way diminishes the oversight role of the Congress. Congress has always exercised its authority whenever necessary, and this change will not inhibit that authority.

Our SBIC venture capital program has been one of the brightest successes in SBA's history. This program is well structured. By attracting private capital – almost 800 million dollars in FY 02 alone – and by encouraging private risk taking, we have the right formula to help small businesses survive and grow. Under our program, the government doesn't make investments in small businesses; privately managed venture capital firms do.

Right now SBICs provide over 65% of all venture financings. In FY 2002, 2.6 billion dollars was invested in close to 2,000 companies in over 4,000 separate transactions. By the National Venture Capital Association's measure, that translates into over 75,000 skilled jobs – in a down year.

We have worked closely with industry representative to provide several legislative changes to the program to allow us to better serve businesses seeking early stage equity investment.

SBA's investment division is committed to continuing to run our New Markets Venture Capital program. Currently, 5 funds have closed and 2 funds are seeking to raise their

private capital. The agency has extended their deadline to the legislated limit of July 9, 2003. We have every hope that the final 2 funds will ultimately raise their capital.

With almost $50 million dollars of government leverage committed to the NMVC program, the agency has a responsibility to manage the program and provide proper oversight. Currently, SBA has committed a staff of 3 to continue this oversight.

In addition to the NMVC program focused on underserved markets, the agency has had tremendous success in reaching underserved markets through its existing SBIC program. Although the program is not mandated to focus on these areas, 25% of all investments made totaling $725 million have been made in Low & Moderate Income (LMI) areas. These dollars account for over 1000 investments in FY2002.

To further demonstrate the success of the SBIC program in reaching underserved markets, when the Low Income (LI) definition from the NMVC program is applied to the investments made by the SBIC program in 2002, we can truly see the impact in underserved markets. 49.7% of all investments made in 2002 were in LI areas, accounting for 1989 investments totaling $1.2 billion.

Overall, I have worked very hard to manage our programs to the best of my ability. I have made changes to programs to allow more loans to be made to small businesses. We are reaching into communities that have lacked business capital, and have more plans to continue in the future. We are using technology to leverage our resources and simplify access. We are also making decisions to be the best stewards of the government's interests. My job, in overseeing Capital Access, is to, as President Bush says, "create the environment where small businesses are able to flourish."

**Statement of Blake Brown**

**Chief Financial Officer, Coastal Enterprises, Inc.**

**Senate Committee on Small Business and Entrepreneurship**

**Roundtable on Reauthorization of SBA Credit Programs: SBA New Markets Venture Capital Program**

**May 1, 2003**

Madam Chair, Ranking Member Kerry and Members of the Small Business Committee, I would like to thank you for this opportunity to be part of this round table discussion of the SBA's credit programs. I would first like to thank you Senator Snowe for all the support you have offered Coastal Enterprises, Inc. over the years and your commitment to strengthening the small business sector in Maine and ensuring that the tools and resources are available to do so.

My remarks this morning are focused on one of the SBA's newest and most unique programs, the New Markets Venture Capital Program

**Background: Coastal Enterprises, Inc.**

Coastal Enterprises, Inc. (CEI) is a private non-profit, 501(c) 3, community development corporation that provides financing and technical assistance in the development of small businesses, social services and affordable housing. CEI development finance activities are targeted to promising sectors, such as manufacturing, value-added natural resource industries, women business owners, microenterprises, select social services (e.g., child care), environmental technologies and others. In addition, CEI engages in the development of affordable and special needs housing, policy research and advocacy.

CEI utilizes many of the financing and technical assistance tools made available through the SBA and these resources have enabled us to better serve the needs of entrepreneurs and small businesses in Maine. In addition to sponsoring a certified New Markets Venture Capital Company, CEI is a licensed SBA 504 certified development corporation, a sub-center under the SBA Small Business Development Center program, a Women's Business Center under the SBA Office of Women's Business Ownership, an intermediary under the SBA Microloan Demonstration Program and an intermediary under the SBA Women's Pre-Qualified Loan Guaranty Program.

Incorporated in 1977, CEI manages a pool of $107 million in loan funds raised from a variety of public and private sources. CEI funds have leveraged over $480 million

in financing for 1,310 small businesses that have created and retained 15,000 jobs. CEI also provides business assistance and training to 1,500 aspiring and existing entrepreneurs each year. In each of its projects, CEI targets social and economic opportunities to low-income people, including welfare recipients and individuals with disabilities. CEI provides a continuum of business finance and support to customers ranging from self employed individuals with limited resources to manufacturing enterprises that employ 100 or more people.

**Experience with SBA New Markets Venture Capital Program**

CEI currently lends and invests throughout the state of Maine and selectively in New Hampshire and Vermont. Maine's population is predominantly rural; only eight communities within the service delivery area have populations greater than 20,000 and the largest urban area has only 65,000 people. Maine is also a poor state, with a poverty rate approaching 20 percent and unemployment rates as high as 9 percent in some areas and per capita incomes that consistently lag behind those for the rest of the region and the country.

The consistent provision of both lending and technical assistance support over the past decade has enabled CEI to expand its capacity to provide the intensive assistance needed to help businesses succeed. It has also helped CEI to extend its reach to underserved rural communities and marginalized populations who would not otherwise have access to these critical services.

It is because of our past positive experience with making both financing and technical assistance available to small businesses to improve their chances for success, that we worked together with CDVCA and other groups around the country to develop the SBA New Markets Venture Capital Program.

Coastal Enterprises, Inc. is the sponsoring organization of a New Markets Venture Capital Company called CEI Community Ventures, Inc. which began investing last month. CCVI is capitalized at $10.2 million with an additional $3 million available for operational assistance to prospective and portfolio companies. Our projected average investment size will be between $100,000 and $500,000 and will seek a triple bottom line return: social and environmental returns will be as important as the financial returns. Our target region for investing is northern New England and includes New Hampshire, Vermont and Maine.

We are very excited about the NMVC Program and the resources – both monetary and operational – it provides for business development in our target States. Equity capital for small businesses in states like Maine, New Hampshire and Vermont is difficult to come by, yet it is precisely the kind of investment capital that is most needed for businesses interested in significantly expanding.

The unique aspect of this program that excites us the most is the provision of operational assistance grants which will allow us to work side-by-side with our portfolio

companies to help improve their chances for success. We will be able to work with companies in developing marketing strategies, sound business plans, human resource capabilities and business processes. These are the needs that go well beyond the standard working capital and fixed asset needs of any business.

Coastal Enterprises, Inc. formed Maine's first socially responsible equity fund targeted solely to business investments in Maine. Since 1997 this fund has invested $5.5 million in businesses that employ over 1,500 workers. One investment in particular is worth noting. It is an investment we made in a company located in Washington County, Maine – a downeast county with a per capita income of roughly $12,500. The company is *Maine Coast Organic Products* that recycles salmon, blueberry, and mussel waste into high-end, value-added garden compost. The investment has been quite successful and in fact you can purchase their product in stores in the Washington, D.C. area. A traditional venture capital fund would not contemplate investing in such a business, yet because of our investment, Maine Coast Organic Products has thrived, is providing much needed employment in one of the country's poorest communities and is having a positive impact on the environment by recycling waste that otherwise would be trash.

The New Markets Venture Capital Program allows us the opportunity to continue making investments of this type – investments in businesses that are located in poor areas – places that traditional venture capitalists avoid; but businesses that promise large returns in terms of the jobs and benefits created for workers living in these areas.

There are many organizations around the country that have been tracking the progress of this program and are looking forward to being able access to it for the benefit of their small business communities. Many of these organizations are members of our national trade association (CDVCA), also testifying here on behalf of the NMVC Program.

Thank you again for providing the opportunity to speak with you today. We look forward to working with this Committee in reauthorizing this very important program.

Colson

May 12, 2003

The Honorable Olympia J. Snowe
Chair
Committee on Small Business and Entrepreneurship
United States Senate
Washington, D.C. 20510

The Honorable John F. Kerry
Ranking Member
Committee on Small Business and Entrepreneurship
United States Senate
Washington, D.C. 20510

Dear Senator Snowe and Senator Kerry:

I would like to thank you for affording Colson Services Corp. the opportunity to participate in your roundtable discussion of May 1, 2003, focusing on reauthorization of the U.S. Small Business Administration's credit programs. JPMorgan Chase Bank, through its wholly owned subsidiary Colson Services Corp., plays an active role in the administration of the SBA's 504 Certified Development Company Program acting as the Agency's Central Servicing Agent (CSA). Given SBA's successful efforts at promoting long-term, fixed rate financing to borrowers, we believe this program should serve as a model public-private partnership for other Federal credit agencies interested in generating additional secondary market activity for their Government-guaranteed loans.

The following information is intended to provide background and insight into the operation of the 504 Certified Development Company Program.

**The SBA 504 Loan Program**

The SBA's 504 Certified Development Company Program was developed to assist communities, both urban and rural, in stimulating growth and expansion for small businesses through the active professional, financial and management services offered by a Certified Development Company (CDC). Growth is measured in terms of job creation and retention. The program assists businesses whose projects will contribute to national objectives such as strong defense, energy conservation, stimulation of new technology, export expansion, minority business development and enhanced productivity and market competition.

CDCs assist qualified small businesses in securing long-term, fixed rate loans, which are guaranteed by SBA, in order to finance plant construction, conversion, or expansion, including acquisition of land, existing buildings and leasehold improvements by the small business. Plant construction includes the acquisition and installation of machinery and equipment.

All SBA 504 loans are originated and administered by the CDCs. Generally, the CDCs approach lenders with qualified small business borrowers, although lenders may identify potential candidates for the 504 Program and put them in contact with a CDC in their community. The lender provides at least 50 % of the funds needed to finance the project, while the borrower generally contributes a minimum of 10% of the project's cost. The balance of the proceeds is funded by the sale of Certificates to private investors, which are backed by SBA guaranteed debentures.

As a result of the 504 Certified Development Company Program, long-term, fixed asset financing by SBA has grown dramatically since its inception. Almost 5,550 504 loans for an approximate total of $2.47 billion were approved in FY 2002. Over the life of the program, more than $16 billion has been funded. Combined with the required private sector financing this represents $42 billion in funding for growing small businesses. This tremendous growth is largely attributable to the solid program structure. Overall, more than 39,000 loans have been approved resulting in the creation or retention of over 1,100,000 jobs since 1980.

**Pooling of Debentures (Funding)**

In 1988, the SBA contracted Colson Services Corp. to perform the role of Central Servicing Agent (CSA) for its 504 Loan Program. As the CSA, Colson facilitates the closing and servicing of SBA guaranteed debenture loans that are originated by approximately 270 Certified Development Companies nationwide.

When an approved 504 project is completed, the loan is closed and the debenture is issued. The complete loan package is delivered to Colson for review and verification against the SBA's database to confirm loan/debenture information, and ultimately to be included in the monthly funding. The Development Company Funding Corp. (DCFC), the representative for the CDCs in negotiations with the Underwriters or Selling Group, is notified by Colson of debentures available for sale. On Tuesday of the first full week of the month (pricing/sale date), DCFC offers debentures and negotiates their sale with the Underwriters. DCFC obtains SBA and Treasury approvals for the rate on the SBA guaranteed debentures and a Purchase Pooling and Exchange Agreement is signed between the Underwriters and DCFC. The resulting pooled debentures are ultimately sold to private sector investors. This securitization process allows an investor to purchase an interest in a pool rather than having to conduct multiple transactions to buy individual loans. The pooling mechanism allows investors to better manage and diversify risk and ensures an efficient transfer of loans and informed pricing by rating agencies or other experts.

On the funding date, the Underwriters deliver the debenture proceeds to Colson and the Trustee delivers Certificates to the Underwriters. Colson then disburses proceeds of the pooled debenture sale in accordance with the instructions provided in the Servicing Agent Agreement. The net debenture proceeds are usually wired to interim lenders who temporarily fund the CDCs until the pooled debentures are sold.

The 504 Program has experienced incremental growth since its inception. At year-end 1991, Colson had funded and converted to its system (from the prior CSA) 5,665 SBA

loans totaling more than $1.5 billion. As of month end March 2003, there were 32,548 active 504 loans on the CSA's system totaling approximately $10.3 billion. Current monthly funding volume averages 379 loans for approximately $164.5 million.

**Monthly Flow of Funds**

As the CSA, Colson is the entity responsible for ensuring loan repayments from borrowers flow through to the program Trustee. The Trustee in turn is responsible for making ultimate payment to the investors. This is accomplished through an Automated Clearing House (ACH) transaction whereby Colson's bank debits the borrower's account for the monthly P&I due, on the first business day of each month. Generally, payments by wire or check are not accepted unless the borrower's bank is in a geographic location not capable of meeting electronic requirements for ACH, the borrower has SBA approval or their ACH payment has already rejected for the month. This arrangement allows the borrower to continue to make payments to only one entity, regardless of the fact that the loan has been pooled and sold to a secondary market investor. On a monthly basis, Colson's bank debits approximately 33,000 borrower's accounts for approximately $101 million. Whereas P&I payments are collected from 504 borrowers on a monthly basis, payment made by Colson to the Trustee on the last business day of each month represents the semi-annual payments due in the given month.

By undertaking this flow of funds and record keeping role, the CSA is in an ideal position to remit information about the program to the sponsoring agency. Such information may include status reports on loans that the CSA services. Because the loan information reporting channels can be designed to regularly involve the CSA, the agent can also become the information gathering point for programmatic, demographic, or other data the Government desires to collect.

SBA's appointment of Colson as CSA along with legislative, regulatory, and market developments since Congress enacted Section 503 of Title V of the Small Business Investment Act has served to further recognize, expand, and improve the efficiency and liquidity of the secondary market in SBA loans. Since inception, the 504 Loan Program has seen dramatic growth in loan volume and improvements in reporting compliance, CDC training, customer service, and communications.

To support its myriad loan administration services, Colson boasts an extensive operational and systems infrastructure, which continues to be refined, to accommodate the changing requirements of SBA's loan portfolio. Colson's proven processes are further reflected in its comprehensive training curriculum where SBA field offices, CDCs and other program participants are trained and/or contacted regularly to keep them abreast of new program rules and policies.

SBA's CSA mechanism is a model blueprint to support secondary market transactions and represents a highly effective public-private partnership. It should also be noted that the 504 Program is self-funding and that CSA contract fees are paid by the program participants. Since it stands as the administrative hub of an important secondary market

loan program, the CSA streamlines payment transactions and systematizes information flow to and from program participants. Specifically, it affords SBA the opportunity to:

- Leverage a proven mechanism and efficient system to promote SBA's secondary market program;
- Access and compile comprehensive portfolio statistics from a secure, centralized database;
- Effectively communicate with all program participants; and
- Obtain complete, standardized information on the secondary market program and loan status reporting.

To the extent the Committee is considering any changes to the SBA 504 Certified Development Company Program, we suggest that any improvements be geared toward making the product more efficient (e.g., less paper and shift to web-based processes). As with other secondary market programs, taking steps to improve the efficiency of the 504 marketplace could attract new sources and larger amounts of capital to the lending market, resulting in a greater volume of business loans at lower interest rates. We look forward to working with the Committee along with SBA, NADCO, Certified Development Companies and other program participants to achieve that goal.

Thank you for the opportunity to comment on this matter.

Sincerely,

Peter J. Casey
Vice President

OMNIBANK, N.A.
397 N. Sam Houston Parkway East, Houston, Texas 77060-2402
P.O. Box 60006, Houston, Texas 77205-60006 (281) 999-9100

July 30, 2002

The Honorable John F. Kerry
United States Senate
Washington, D.C. 20510

RE: Proposed Senate Bill

Dear Senator Kerry:

Please accept this letter as my full support of the bill, soon to be introduced, proposing a Pilot Program, operating through the Small Business Administration's 504 Loan Program, that would allow Day Care facilities designated as non-profits to be eligible for the program.

I believe the demand for such a product is strong, and is fiscally sound. My reasons are as follows:

1. Day Care Centers must carry a non-profit designation in order to accept children to the center from low- income families.
2. These businesses benefit low-income neighborhoods and enterprise zones by purchasing property, improving the physical appearance of the community and providing safe facilities for the children. The ability to utilize the SBA-504 program would enable these businesses to decrease lease/payment expense and hence, help more children.
3. These families are in the most need for quality day care facilities in their community, since many use mass transit to get to work.
4. Small businesses have provided most of the job growth in this country in the last ten years. By enabling these Day Care Centers to operate efficiently and provide quality facilities, we will be helping small business gain and maintain employees.
5. Designation as a non-profit business does not equate to an inability to pay loans, or other business expenses.

OMNIBANK, a 50-year-old community bank in Houston, Texas, has experienced a consistent demand for loans to Day Care Centers. Most loan requests from these entities are for the purpose of acquiring or expanding property (real-estate) or acquiring transportation equipment. An example of a specific, recent request follows:

**The Executive Director and Owner of Teeter Totter Day Care Center approached OMNIBANK about a loan to purchase the building used to house the Center. The owner, an African-American woman, was experienced in this business. Cash flow to service the debt was sufficient and appropriate under prudent lending guidelines. The only deterrent from making a conventional loan was the amount available for down payment. Twenty percent or more is usually required.**

**Under the SBA-504 Program, a ten percent down payment is allowed and standard procedure for multi-use buildings. Additionally, it offers a fixed rate on the SBA portion of the loan. Most small businesses do not have access to fixed rate mortgages, due to the size of the loan requests, which enhances the attractiveness of the SBA 504 Program even further.**

**As we were preparing the request package, we realized that a non-profit did not qualify. The owner would personally guarantee the loan, and even agreed to form a for profit corporation to hold the property, because the underlying tenant was non-profit it would not work. The owner could not change Teeter Totter into a for profit corporation without jeopardizing its subsidies for low- income children.**

**OMNIBANK and the day care center are located in Houston's fifth ward, most of which is classified as low to moderate income. Its population is primarily low-income African Americans and Hispanics. The project was viewed by the Bank as a good loan from a business perspective, with many additional benefits to the community at large.**

Ultimately, after appealing to SBA for an exception, and spending a great deal of time on the project, the loan was not completed. This delayed a good project from improving many aspects of an already underserved community, due to a simple tax classification.

As stated earlier, OMNIBANK receives consistent requests from day care centers, most of which are non- profit. I believe that a Pilot Program as proposed, will prove that these are viable and valuable businesses. I would recommend that all other standard criteria, proven track record, cash flow, management expertise, etc. remain.

I look forward to any questions you may have, or any further examples I can provide.

Sincerely,

Julie A. Cripe
President and Chief Operating Officer

Cc: Ms. Kevin Wheeler

**Additional Information for the Record of the Senate Small Business and Entrepreneurship Committee Roundtable of May 1, 2003**

**GAO's Analysis of Borrower Inquiries and Complaints Received by SBA Since the First Loan Asset Sale, August 1999, Through April 2002**

**Submitted by: Davi D'Agostino, Director, Financial Markets and Community Investment, U.S. General Accounting Office**

**Scope and Methodology**

To determine the types of inquiries and complaints borrowers had, we reviewed 133 of 155 borrower inquiry and complaint letters filed at headquarters since the first loan sale in August 1999. We collected information that included the date and type of inquiry or complaint (for example, questions about a loan sale or complaints about a servicing action by a purchaser) and the name of the purchaser (if available). We also created a summary of SBA's written response. Our analysis of the types of complaints received at headquarters, as reported in Appendix II of our report, is shown below.[34]

We also interviewed SBA officials at headquarters and field offices (three servicing centers, seven district offices, and two disaster area offices) about the types of inquiries and complaints they received from borrowers and about SBA's process for handling these complaints. In addition, we asked staff at field offices whether they had forwarded borrower complaints to headquarters or documented the complaints. We reviewed a nonstatistical sample of complaints from the third, fourth and fifth sales drawn for us by staff at one of the disaster home loan servicing centers to determine whether the information in borrower complaints received at field offices was accurately represented in headquarters records. Specifically, we compared the names on the complaints we received from the disaster home loan servicing center to the names on the complaints at headquarters. This analysis is also included in our January 2003 report (page 24) and is shown below.

We also reviewed the complaints logged through the toll-free number, which SBA established in August 2001, but these data were limited because SBA staff did not begin logging the complaints from this number until April 2002.

**Types of Borrower Inquiries and Complaints Received by SBA**

We reviewed 133 of the 155 inquiries or complaints SBA had documented from August 1999 through April 2002 to identify the types of concerns and problems borrowers faced when their loans were sold.[35] From our review, we determined that borrowers generally contacted SBA about loans that have been sold for one of two reasons:

[34] U.S. General Accounting Office, *Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain*, GAO-03-87 (Washington, D.C.: January 2003).

[35] We tried to review all of the inquiries and complaints documented at headquarters and stored in two binders. However, we did not include in our review additional follow-up letters from the same borrowers. Furthermore, the

- they have a question or concern about why SBA is selling their loan, or they want to purchase their loan rather than have SBA sell it to the private sector; or

- they want to modify their loan and have a complaint about the purchaser's procedures or treatment.

Almost half (65) of the 133 letters from borrowers that we reviewed at headquarters involved questions about why loans were being sold, requests to buy a loan discounted lower than the unpaid principal balance, or pleas that the loan not be sold. Forty-seven letters referred to purchasers' servicing actions. Twenty-three of these letters involved disagreements or frustration with servicing decisions the new purchaser had made, such as refusing to subordinate or release collateral,[36] or imposing a fee to complete a servicing action such as subordination. Another 18 letters came from borrowers who wanted to defer payments or change the amount of their monthly payment because of financial problems and felt they were not getting appropriate treatment from the purchaser of their loan. Six of the letters complained about problems that occurred while SBA was transferring the loan to the purchaser. For example, some borrowers found that purchasers had not properly applied their loan payments during the servicing-transfer period. Nineteen of the remaining 21 letters came from borrowers who wanted SBA to subordinate, release collateral, or compromise on a loan's payment or terms, and who were told that SBA had sold the loan and thus could no longer service it.

**Work Conducted at SBA Field Offices**

We reviewed 50 complaints from a servicing center, the only field office we talked to that could provide a record of phone calls and letters from borrowers whose loans had been sold, to compare them to the inquiries and complaints at headquarters. Forty-five complaints involved problems with purchasers during the servicing transfer period—for instance, some borrowers said that payment had not been posted and others had difficulty modifying the terms of their loans. However, we found that only 3 of the borrowers listed in 50 complaints from the servicing center were reflected in the 155 borrower inquiries or complaints we reviewed at SBA headquarters. An SBA official at headquarters told us that the office had received some of the complaints from the center but acknowledged that they had not included these complaints in the files we had reviewed.

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database SBA created after our review included inquiries and complaints after April 2002, when we had reviewed the inquiries and complaints at headquarters. Therefore, our 133 complaints did not match exactly the 155 complaints in SBA's database.

[36] "Subordination" occurs when a lender allows a new or existing loan to take a superior lien to another loan. For example, a borrower with an SBA disaster home loan may want SBA or a lender to subordinate the disaster loan to a new or refinanced home mortgage.

*The Commonwealth of Massachusetts*
*Executive Office of Health and Human Services*
*Office of Child Care Services*
*Central Office*
*One Ashburton Place, Room 1105*
*Boston, Massachusetts 02108*

JANE SWIFT
GOVERNOR
ROBERT P. GITTENS
SECRETARY
ARDITH WIEWORKA
COMMISSIONER

TELEPHONE
(617) 626-2000
FAX: (617) 626-2028
TTY: (617) 626-2066

July 11, 2002

Chairman John Kerry
Senate Committee on Small Business and Entrepreneurship
428A Russell Building
Washington, D.C. 20510

Dear Chairman Kerry:

The Massachusetts Office of Child Care Services (OCCS) fully supports expansion of the SBA 504 loan program to include non-profit child care programs. OCCS is the state's licensing agency responsible for setting and enforcing strong health, safety and education standards for child care programs throughout the Commonwealth. OCCS is also the lead state agency responsible for the administration and purchase of all human services child care subsidies across the state. As a result, this agency is greatly invested in the viability of these child care programs and in increasing the capacity of child care services to benefit more families in the Commonwealth

Currently there are approximately 17,000 licensed child care facilities in the Commonwealth which can provide services to over 200,000 children. Many of these facilities are non-profit programs[1] that serve low-income families that are receiving child care subsidies to help them become or remain employed, and families that are or were receiving TANF. The availability and accessibility of child care is one of the main reasons that families can continue to successfully transition from welfare to work. There are currently approximately 18,000 children on the waiting list for a child care subsidy. The reauthorization of TANF may further increase the number of families seeking subsidized child care and Massachusetts must be ready to provide quality care. Accordingly, current and future non-profit programs will greatly benefit from the expansion of the SBA 504 loan program, as will the families that they serve.

OCCS is a member of the Advisory Committee on Child Care and Small Business and fully supports the Committee's mission of uniting the small business and child care

[1] Based on OCCS data, 2,057 centers and school-age programs are non-profit, while only 1,196 are for profit.

communities to help providers maximize their income while providing quality child care. Expansion of the SBA 504 loan program will undoubtedly help expand the availability and accessibility of quality child care. Thank you for your support of this important legislation. If I can be of further assistance please do not hesitate to contact me.

Sincerely,

Ardith Wieworka

Ardith Wieworka
Commissioner

# STATEMENT

By

**Virginia Asset Financing Corporation**

On

# The Small Business Administration

# 504 Loan Guaranty Program

# Proposed 504 Reauthorization

Submitted to the

## Committee on Small Business & Entrepreneurship

## United States Senate

By

**Sally B. Robertson**
Executive Director
Fairfax, Virginia
May 5, 2002

Virginia Asset Financing Corporation is pleased to participate in the Roundtable discussion and to provide a statement to the Senate Committee on Small Business & Entrepreneurship regarding the reauthorization of the SBA 504 Loan Guaranty Program. We are one of 260 CDCs who deliver the 504 program to small businesses across the country. As Virginia's statewide CDC, we have assisted over 1,000 small businesses to finance over $1 billion in projects resulting in the creation of over 12,000 jobs.

We, and the other CDCs, could not have made such an important economic impact without the ongoing support of Chair Snowe, Ranking Member Kerry, and the entire Committee. This program is critical to the growth of small businesses, and without your support, small businesses would not have access to this vital source of financing.

504 Reauthorization

The 504 program is critical to growing small businesses. During a growth cycle, a small business typically outgrows its facility or requires additional machinery and equipment to keep up with demand. However, the business finds its cash flow constrained by the other demands of growth – increased payroll, increased inventory, and increased accounts receivable. There is simply insufficient cash available for the small business to make the critical investments in plant and equipment through conventional financing sources. Our small businesses will consistently state that the 90% financing provided by 504 was essential to their expansion. Additionally, the long term and reasonable fixed rate allowed them to remain competitive and expand successfully.

At a time when unemployment is rising and the economy is sluggish, with no cost to the taxpayer, and with a track record of creating jobs, it would seem important that the 504 program be reauthorized at increasing levels for the next three years. Additionally, the user fees must also be extended for a three year period to eliminate the need for taxpayer subsidy for the program. NADCO has prepared detailed information on proposed program authorization levels and outlined the various fees that must be extended. We urge that NADCO's proposal be supported by the Committee rather than the SBA's budget proposal.

Streamlining

Our small businesses would typically say that the 504 loan was critical to their ability to grow to the next level. However, 100% of our small businesses would say that the amount of paperwork required to complete the loan was overwhelming. To point out to the Committee the critical need for streamlining the paperwork associated with the SBA 504 loan program, an actual loan application package (approximately 6 inches thick) and an actual loan closing package (approximately 8 inches thick) were presented. These two packages represent the paperwork needed to conclude one $300,000 loan transaction. This is an excessive burden for small businesses and must be reduced.

Centralized Processing

In addition to the burden on small business, SBA personnel cannot be expected to properly complete their jobs when faced with thousands of similar packages to review on an annual basis. Streamlining is particularly essential for Centralized Processing to be effective.

Centralized processing of 504 loans is critical to small businesses. We are in an age of instantaneous information, instantaneous communication, and rapid credit decisions through credit scoring. We can no longer take months to process a loan application. In today's fast paced world, a property seller will not allow a lengthy feasibility or financing contingency. If we are unable to be responsive, the small business may lose its ability to expand and the jobs it would have created will be lost to the community.

SBA continues to see its highly experienced and qualified staff retire. Centralized processing can assist SBA with its staffing issues as it did with loan servicing. CDCs are on the whole very pleased with the results of centralized servicing, and we have been able to provide faster, more consistent decisions for our small businesses.

504 Program Enhancements

1. PCLP regulations and loan loss reserve: Virginia Asset is the 18th largest CDC in the country, but we do not participate in the PCL program for two reasons. First, our Board of Directors is risk adverse, and with no regulations as yet issued governing the program, our Board will not agree to participate. Second, the loan loss reserve requirements are too onerous. There is no adjustment to the reserve as the loan amortizes and/or no risked based analysis of the loan loss reserve. The CDC could be at risk by committing so much of its annual revenues to such a restrictive loan loss reserve.

2. Job creation ratio: The cost to create a job has risen over the last thirteen years, particularly the cost of facilities and equipment for manufacturers. If a business will not create jobs at the required level of 1 per $35,000 loaned, we must turn the business away. Many manufacturers cannot create sufficient jobs to meet this standard, but are creating higher paying jobs with benefits. We need to be able to assist those businesses because those jobs are vital to the community. Raising the standard to 1 job per $50,000 loaned will allow us to assist more businesses whose cost to create jobs has grown over time and whose jobs are typically of a better quality.

3. Increased Debenture Size: The 504 loan program size standards allow us to assist a mid-size small business, but the loan size limitations do not allow the 504 program to be a participant in projects typical of this size business. Many of these projects would be in the $5 to $10 million range, while sensible credit determinations would keep the 504 program with its $1 million maximum in the under $5 million project range. In particular, a larger debenture of $2 million to $2.5 million would be most beneficial to manufacturers.

4. Definition of Rural Areas: It is absolutely essential that SBA immediately begin using the same definition of rural as the Department of Agriculture. Counties with populations of less than 50,000 should immediately be classified as rural. This would allow 504 to assist businesses in those areas. Those small businesses are essential to the rural communities, particularly given the rising unemployment rates.

5. Other: NADCO has proposed other program changes that would certainly be beneficial to the small business community allowing us to assist more small businesses who will in turn create more jobs. The top four items discussed

would, in our opinion, assist the most small businesses immediately, but we also support NADCO's full legislative agenda and comments.

Duplication between 504 and 7(a)

Chair Snowe asked at the Roundtable whether there was duplication between these two SBA loan programs and whether there was a need for both programs. Participants answered that the two programs were created with entirely different missions: the purpose of the 7(a) program is to provide gap financing while the purpose of the 504 program is to promote economic development principally through job creation. SBA indicated that both programs finance the same top four industries – hotels, restaurants, gas stations, and convenience stores giving the impression that the programs are indeed duplicative. It is important to note that the acquisition/improvement of the real estate is important to the operation of the business for all four of these industries.

Although we all agree that the missions are significantly different for the two programs, the most obvious differences are seen at the operational level. Those differences are dramatic and important to the small business. First, the 7(a) program can finance projects and costs that the 504 program cannot. For instance, the 7(a) program can refinance existing debt for a hotel, restaurant, gas station or convenience store when the refinancing will improve cash flow. 504 is not permitted to refinance, only assist with the original acquisition or a subsequent improvement to the property. Thus, the industries as noted by SBA that are most frequently financed by both programs may not be duplicative at all. Both programs are providing financing to industries that most frequently acquire or improve the real estate that their business operates from, but it may be for different purposes.

Second, the terms of 7(a) loans are generally less beneficial for the small business than 504 loans. 7(a) lenders generally require a 20% down payment while the 504 program is typically limited to 10%. This difference is critical to the small business acquiring a new plant or equipment with a need to preserve working capital for operations. Also, the 7(a) lender can achieve the highest profits from secondary market sales by requiring a floating interest rate. Generally, the 504 rate is as much as 1% less than the 7(a) interest rate and is fixed for 20 years. The small business can fix its costs for plant or equipment by using the 504 program. When a small business can use either program and is given a side by side cost comparison, in our experience, they will consistently choose the 504 program due to its lower down payment, fixed rate, and lower cost.

Small businesses need both programs. Overall, different needs of small businesses are met by the two programs, and it is important that both are available.

Summary

Thank you for the opportunity to attend the Roundtable and to offer some insights on behalf of the small businesses that we serve. Delivering the 504 Loan Program is extraordinarily rewarding, and the small businesses who benefit from the program are not seeking handouts but an opportunity to grow and prosper. We should continue to assist them by reauthorizing the 504 program, reauthorizing the fees to keep the taxpayer cost at zero, and adding enhancements to increase the number of small businesses assisted.

# POST ROUNDTABLE QUESTIONS

SBA Reauthorization: Credit Programs

Post-Roundtable Questions

Senator John Kerry questions for Chris Crawford:

1. **Question: Please explain to the Committee what the current requirements for PCLP are and what NADCO is requesting as an alternative.**

In 1994, Public Law 103-403 established the Premier Certified Lenders Program on a pilot basis as section 508 of the Small Business Investment Act of 1958.

Under this program, proficient CDCs could receive delegated authority to approve debentures on behalf of the Agency (and to foreclose defaulted ones) providing the CDC agreed to reimburse SBA for 10 percent of any loss sustained by it on debentures approved by the CDC under the pilot program. The benefit to the CDC would be much faster loan approval and for the Agency, it would stretch limited resources. The program was deemed a success and in 2000 it became a permanent program pursuant to Public Law 106-554.

In order to assure that there would be funds available from which the CDC would reimburse SBA for losses, the CDC is required to establish a loss reserve fund in an amount equal to 10 percent of the CDC's exposure to SBA under the PCLP program.

Some CDCs, particularly those who entered the pilot program, are processing a large volume of their debentures through the PCLP program, and loss reserves of several companies are at the $1 million level and growing, while others are approaching this same magnitude.

**Question: Does NADCO's proposal differ from the Administration's proposal for modifying the PCLP loan loss reserve requirements?**

NADCO's proposed changes to the Small Business Investment Act of 1958 addresses the concept of risk-based loan loss reserves in a manner very similar to the legislative proposal of the Administration. However, several important differences do exist.

First, the NADCO proposal includes an alternative for PCLP reserves maintenance that we believe may be attractive to many smaller CDCs that wish to participate in PCLP. Under this alternative plan, the total required balance of loan loss reserves could be maintained at a level equal to 1% of the outstanding debenture balances of all the loans made by the CDC under the PCLP program. Thus, as the loan balance was paid down over the years, the loan loss reserve could be reduced to match the outstanding loan balance. This would enable a CDC to withdraw some funds from its reserves to be utilized for other operational purposes or to make even more loans under the PCLP program. It would also continue compliance with Congressional direction that the CDC loan loss reserve be at least 1% of the government risk for a 504 loan.

When the PCLP program was established, the statute did not recognize that the amount o SBA's risk of loss decreases as the debenture ages. Debentures are issued for either a ten or twenty year term and are amortized, i.e., the borrower repays part of the financing every month just as most home owners do on their mortgage, but the amount of the CDC's loss reserve or

security never decreases until the debenture is fully paid off. Thus as the principal on the debenture decreases each year and the amount of the reserve remains constant, the reserves as a percentage of the outstanding loan balance actually increases.

For example, a 20-year debenture for $414,000 with an interest rate of approximately 4.8 percent would require a CDC to contribute $4,140 to the loss reserve.

By the end of year 5, the principal would be reduced to approximately $344,000, but the loss reserve, which was originally 1 percent, would now be 1.2 percent of the loan balance.

By the end of year 10, the principal would be reduced to approximately $255,000, but the original loss reserve of 1 percent would have increased to 1.6% of the current loan balance.

By the end of year 15, the principal would be reduced to approximately $143,000, but the loss reserve of $4,140, which was originally 1 percent, would have increased to 2.9 percent.

And it continues to grow so that by the end of year 19, a reserve of 1 percent has increased to more than 14 percent of the loan balance.

In other words, after 19 years the CDC is maintaining a reserve of $4,140 to assure that it will pay 10 percent of any loss and yet the principal has been paid down to $29,000 and the CDC's share would be only $2,900 or less than the amount in reserve.

Finally, however, under current law the debenture will be completely paid, and then and only then is the CDC permitted to withdraw from the reserve the entire $4,140.

It appears much more logical to amortize the amount of the loan loss reserve the same as the debenture amortizes, thereby reducing the amount of the required reserve as the borrower repays the indebtedness.

NADCO requests that the mandatory reserve be reduced annually as the debenture is repaid and the CDC be permitted to withdraw a proportionate amount of the reserve but maintaining the minimum amount of the reserve throughout the life of the debenture at the initial requirement of 1 percent.

Second, a significant restriction of the current law requires that all PCLP loan loss reserves be maintained as deposits at Federally insured depository institutions. In the early years of the pilot program, these restrictions on investments did not present much of a problem. Recent increased use of the PCLP program, however, demonstrates that CDC loss reserves can build to very large balances and can easily exceed the current Federal deposit insurance limit of $100,000.

In today's economic climate, these cash reserves are yielding interest rates that do not even equal the low rate of inflation. NADCO's proposed language enables a PCLP CDC to maintain alternative reserves in the form of Treasury Bills, Treasury Notes, Government Agency bonds, or investment grade corporate bonds. With little or no real market risk for these instruments or funds of such investments, improved long term yield for loan loss reserve assets will provide added financial security for CDCs.

Third, while both NADCO and the Administration propose a loan loss reserve alternative based on the calculated risk of the CDC's PCLP portfolio, there are minor differences. NADCO suggests a minimum balance of $25,000, while the Administration has recommended a minimum reserves balance of $100,000. NADCO is now considering its support for this Administration new minimum amount.

When Congress was considering establishing the PCLP program, there was concern that the CDC (to whom SBA would delegate decision making authority) should have a financial stake in approving the loan and not simply act as a rubber approval stamp with SBA bearing all the liability. Thus the CDC was required to agree to assume 10 percent loss exposure and to establish a loss reserve of 10 percent of this exposure.

Although some 25-30 CDCs have elected to seek designation as Preferred Certified Lenders, many have not done so due to the required assumption of risk and the excessive amount of the mandatory loan loss reserve. Some have voiced the opinion that the amount of the reserve is completely arbitrary and is not based upon any loss study.

Other industries, such as the banking industry, have already moved from a "loan-by-loan" reserve to a "pool" reserve to cover their exposure to loss. Such reserves are based on overall portfolio risk.

Obviously the goal would be to establish a more accurate computation of the necessary reserve that would be based upon the actual loss experience of each individual CDC. The reserve would be established in an amount sufficient to protect the Government and the taxpayers from risk of loss due to default, but the amount would not be excessive and would free funds that the CDC could use to help provide additional assistance to small business.

Due to the complexity of establishing a loss reserve for each CDC, there would be cost involved to the CDC. Not all CDCs would elect to conduct the necessary study and they should not be required to do so. Instead, they would continue to fund a 1 percent loss reserve without regard to their actual loss experience, but it would be in proportion to the amount of the debenture remaining unpaid as is discussed above.

Other CDCs, however, especially those with higher loan volume, might elect to do a loss study, anticipating that it would show that an adequate loss reserve would be in a lower amount based on that CDC's actual loss experience. We believe this option should be provided.

NADCO requests that CDCs who elect to participate in the PCLP program be allowed to establish a risk-based reserve to protect the Government against loss as an alternative to the 1 percent loss reserve requirement. This alternative would be available to a CDC only if (1) the CDC voluntarily elects to participate, (2) the CDC has experience as a PCLP participant and has a loan loss reserve of at least $25,000, (3) the CDC contributes such additional amounts as are determined necessary by a third-party auditor employed by the company to protect the Federal Government from the risk of loss associated with the portfolio of PCLP loans of the company and (4) the SBA determines that the CDC has established a process for analyzing the risk of loss associated with its portfolio of PCLP loans and for grading each PCLP loan made by the company on the basis of the risk of loss associated with such loan.

In summary, both the Administration and NADCO propose to create a reserves calculation method that is new to this program, but very commonplace in the financial services and commercial lending world. In fact, commercial banks have been successfully using risk-based reserves management for many years. The result is that the U. S. banking industry remains one of the best managed and financially sound banking systems in the world. Even financial calamities such as loan losses due to major corporate bankruptcies (including Enron and MCI) have not resulted in bank failures by their lenders.

NADCO believes such a system can be applied to the 504 program and lending CDCs. The Administration agrees with the industry. Both plans require that the SBA develop operating regulations given the broad guidance of legislation.

With only the question of the amount of the loan loss reserves at issue, NADCO is prepared to work closely with the Administration to devise reasonable procedures and regulations.

2. **Questions concerning child care facilities: Please share with the Committee concerns about SBA's methods and track record of liquidating non-performing loans and specific recommendations. (Responses to these questions are also provided by Ms. Sally Robertson on behalf of NADCO.)**

Over the last four or five years, SBA has utilized its asset sales as the primary method of obtaining some amount of cash recoveries from 504 and other SBA defaulted loans. Over the same time interval, the OMB forecast of net 504 loan recoveries has fallen from 40% to only 17% for FY 2004's subsidy model. This progressive decline in program recoveries reveals that the methods being utilized by SBA are simply not working.

This has been recognized by both the GAO and the SBA Administrator, who recently halted asset sales as the agency's primary means of loan asset recovery. It is not clear how SBA will now seek to recover cash from defaulted loans, as no new procedures have been announced. However, NADCO is extremely concerned, as the net loan recovery estimate is one of the primary factors in the program subsidy model.

Of additional concern to NADCO is the fact that the SBA portfolio management staff may have been reduced over the past five years, as asset sales were completed and fewer loans liquidated through a workout or legal actions by the agency. If SBA attempts to return to using its own staff to complete recoveries, we believe this process could result in insufficient allocation of human resources to the effort. The end result may be even less actual net loan recoveries.

Our final concern about SBA liquidation efforts is that the agency has never implemented the statutory requirements of P. L. 106-554, Section 307 (a), dated 12-21-2000, which recognized the success of the Congressional pilot program to enable CDCs to liquidate, litigate, and recover cash for defaulted 504 loans through their direct actions. During a three-year pilot, approximately twenty CDCs demonstrated that they could obtain net recoveries of 50% or greater in many default cases.

As we discussed during the Senate May 1st roundtable, NADCO continues to believe that SBA should be required to fully implement the provisions of this law as quickly as possible. With asset sales failing to produce adequate program recoveries, and our expectation that new loan defaults will be assigned to a smaller and overworked SBA staff, we believe there must be increased recovery effort made through the private resources of Certified Development Companies. This was the case three years ago, and remains true today.

Therefore, our primary recommendation is that Congress ensure that P. L. 106-554 is fully implemented.

RESPONSE TO POST-ROUNDTABLE QUESTIONS

Committee on Small Business Business and Entrepreneurship

By Sally B. Robertson

"SBA Reauthorization: Credit Programs"
May 1, 2003

Questions from Senator Olympia J. Snowe, Chair

(Please note that these responses are my personal opinions and do not represent the position of the National Association of Development Companies.)

Remembering that the 504 program only provides financing for facilities and not for working capital, inventory (i.e., day care program supplies, food, etc.), or training:

1. The definition of eligible organizations should include:
    a. The organization must be properly licensed by the appropriate jurisdictions in which they operate to provide child care services
    b. There must be clearly identified collateral supporting the 504 loan to permit foreclosure in the event of default. If the facility is part of a larger facility, the 504 loan must be adequately and properly secured or outside collateral must be identified to secure the loan.
    c. No portion of the facility could be used as a personal residence
    d. Personal guarantees must be required. Directors and key employees of non-profit entities typically do not provide personal guarantees, and this could become a vehicle for obtaining SBA financing without personal recourse.
    e. Religious education must not be a part of the curriculum
    f. Day care should not be a minor part of a larger non-profit entity's revenue sources. At least 75% of revenues should be derived from day care operations. If the day care operation is insignificant to the business operation, it may not receive sufficient management attention or resources to be successful.
    g. If the day care operation is part of a larger non-profit entity, at a minimum, separate accounting should be maintained for the day care operation. A separate entity would be preferred.
2. Private, non-profit grade schools with a day care component:
    a. Schools providing religious education should be excluded, but otherwise, non-profit schools with a day care component should be eligible for 504 financing provided they meet existing SBA regulations on size standards and the day care revenues constitute more than 75% of their total revenues.
    b. Separate accounting should be maintained for day care operations
3. Private, non-profit schools through high school also providing day care:

   a. Same answer as Question 2 – as long as day care is the major component of the program, the grades taught by the school should not be a deciding factor.
4. Private universities or colleges that have not established separate entities for child care providers
   a. Publicly funded universities or colleges should not be eligible for 504 financing.
   b. Without experience in reviewing financial statements for colleges and universities, it is difficult to offer expertise on this question, but intuitively, it seems that this type of entity would be too large and too diversified to fit the profile of the typical small business receiving SBA financing.
   c. Since the university or college would also need to meet SBA's sizing standards for small business and the credit elsewhere test for liquidity, it is conceivable that many private institutions for higher learning would not be eligible. Since the college or university would be considered an affiliate of a separate day care entity, and affiliates are included in the sizing standards, again, many, if not all, would not be eligible.
   d. Given the requirement recommended that the day care component should not be a minor part of the revenue of an entity receiving funding, most or all colleges and universities may be eliminated from receiving 504 funding.
   e. Personal guarantees would most likely be an issue for colleges and universities, since paid staff and managers would not likely agree to guaranty 504 loans for the day care facilities.
5. Non-profit entities with on-site child care
   a. SBA has only been permitted to finance for-profit businesses, and CDCs have not developed expertise in lending to non-profit entities such as associations, although we have developed expertise in lending to day care facilities. If the 504 program provides financing for non-profit entities other than those whose mission is to provide education or child care as their primary purpose for existence, then SBA should simply provide financing for all non-profit entities through its programs. The underwriting process would require the CDC to understand and underwrite the non-profit entity hosting the day care facility to assure repayment ability, meaning we would need to develop expertise in lending to a variety of non-profits. The learning curve would likely result in higher defaults temporarily.
   b. Item requirements 4(c), 4(d) and 4(e) would also apply here.
6. Religiously-affiliated child care providers
   a. As stated above, the religious organization would need to provide specific loan collateral, either through the buildings and land being utilize for the day care facility, or through other collateral of equal or greater value. SBA's ability to obtain title through foreclosure processes would be a major concern.
   b. Personal guarantees would be required.
   c. As with any 504 borrower, the revenues of the day care center would need to constitute the majority (or 75%) of the business revenues.

<u>Questions submitted by Senator Kerry, Ranking Member:</u>

1. Day care facilities as special purpose assets
   a. Special purpose is a two-fold definition. First, the asset is specifically designed or has unusual features that limit its usefulness to a specific industry, and a different user would incur significant cost to refit the asset to a more general use. Second, the marketability of the asset is adversely impacted by these features (i.e., there is not a large, ready pool of purchasers). For instance, quick lube and oil change facilities have a large pit in the concrete floor that would not be useful to any other industry, or an equestrian facility with fenced pastures, barn with horse stalls, and indoor and/or outdoor riding arenas is limited to equestrian uses. In our market area, neither of these facilities are considered a "special purpose asset" under the appraisal definition because they are readily marketable meaning a large number of buyers is readily available to purchase these properties (we are located in Virginia) at a "fair market value".
2. What makes day care facilities special purpose, is it justified, and should relief be provided?
   a. Day care facilities might be considered special purpose because of small, child-size fixtures installed in the building (toilets, sinks, etc). The land area typically used for a playground might be considered excess land, but it could be either sold off or converted to parking spaces (day care facilities typically are not required to have the same amount of parking as a comparably sized office building).
   b. In our market area, the appraisers do not consider these as significant enough to limit the use of the building (the cost to remove the fixtures is not significant) and do not classify day care centers as special purpose.
   c. Unless a building has very unusual design elements so that no other business could readily convert the property to office use, day care properties would generally not be considered special use. However, I would be reluctant to change SBA's policy of relying on the appraiser to make the determination as to whether or the property is special purpose. Each market and each project is different, and the appraiser is best suited to make the determination.

3. SBA's method and track record of liquidating non-performing loans
   a. If a loan becomes 65 days past due, SBA is required to purchase the debenture, and the CDC loses control of the work out process. While we understand that SBA is trying to minimize the impact to the taxpayer by repurchasing the debenture early to avoid additional accrued interest, the best business decision (i.e., the best opportunity to get the SBA fully repaid) cannot always be made in this time frame. Additionally, SBA has policies (i.e., not permitting a compromise when a subordinate lender is receiving any payment) can cause SBA to lose its entire loan rather than recover at least some of the money. Personal guarantees are required, but SBA does not seem to make significant recoveries from those guarantees or from additional collateral.

b. As a CDC, we make every effort to exhaust the available avenues for recovery that are open to us before we turn the loan over to SBA. Since our options are very limited, it is a struggle. For instance, we had a machinery & equipment transaction with additional collateral consisting of the personal residence and a residential investment property. The first trust lender had a 7(a) working capital loan as well, and put all of the receivables (and collections) in a lockbox and refused to allow the business to make any payments on the 504 loan. We convinced the borrower to sell their personal residence which had sufficient equity to pay off the 504 loan. It took several months to get the house listed, sold and settled, and the 65 day rule was a constant problem since the bank refused to permit any payments on the 504. Once concluded, the sale netted sufficient funds to pay 100% of the principal and accrued interest and 50% of the late fees.
c. Our experience with SBA liquidations has not been good through no fault of the SBA personnel. Work outs are time intensive, and SBA staff are constrained by policies and unable to handle the large volume of liquidations. SBA rarely purchases a first trust loan, meaning there is no opportunity to collect from the project collateral once the first trust lender has foreclosed. We have attempted a private auction in cooperation with the first trust lender on three occasions, but two were unsuccessful because of the nature of the properties. The third repaid almost the entire 504 loan.
d. The asset sale route has not been a good alternative for our 504 loans. Recently, a 504 loan was sold in the asset sale just days before the bank foreclosure. We knew there was value in the property to repay at least half of the 504 loan amount. A private bidder bid enough at the foreclosure auction to pay the first trust lender and half of the second trust. In this case, the money went to the asset sale purchaser, not SBA.
e. The CDC Liquidation Pilot was made permanent, but regulations have not been issued. This will be an expensive undertaking for CDCs who must dedicate staff and fund upfront liquidation costs, and no CDC should be required to participate in a program that has no rules.

# COMMENTS FOR THE RECORD

SEED CORPORATION
SOUTH EASTERN ECONOMIC DEVELOPMENT

80 DEAN STREET
TAUNTON, MA 02780
TEL. (508) 822-1020
FAX. (508) 880-7869
www.seedcorp.com
info@seedcorp.com

July 10, 2002

Chairman John Kerry
Senate Committee on Small Business and Entrepreneurship
428A Russell Building
Washington, DC 20510

**RE: Non Profit Child Care Center Eligibility Under the SBA 504 Program**

Dear Senator Kerry:

As a member of the Advisory Committee on Child Care and Small Business as well as Vice President at South Eastern Economic Development (SEED) Corporation, I am writing in support of the idea of expanding the SBA 504 program to allow for non profit child care centers to be eligible for financing under the program. SEED Corporation is a Certified Development Company certified and accredited to administer the SBA 504 program throughout southeastern Massachusetts. Over the past 2 years, SEED has been the number one SBA 504 lender in the state. SEED is also an approved SBA Microenterprise Intermediary and we have enjoyed and made use of the ability to provide micro loans to non-profit child care businesses since the microenterprise intermediary legislation made the special provision for non profit child care providers to be eligible for SBA micro loan funds. My primary responsibilities at SEED include origination, underwriting and closing SBA 504 loans as well as the oversight and development of SEED's micro loan and business assistance activities.

Over the past five years, SEED has assisted over 10 FOR-PROFIT child care businesses to obtain SBA 504 financing for their start-up or expansion projects. However, we have also had to turn away an equal number of non-profit child care centers that were seeking similar assistance due to the fact that non profit entities are not eligible under the SBA 504 program.

As we have learned from discussions and analysis within the Advisory Committee on Child Care and Small Business, access to long term, fixed market or below-market rate financing is essential to any child care center. The slim margins that characterize this industry limit any child care center's ability to grow. The SBA 504 program offers the type of fixed rate financing that not only assists the business to keep its occupancy costs under control but also serves to stabilize its operations over the long term. The program also provides an incentive to a bank to provide fixed asset financing to a business that might not otherwise be able to afford a conventional commercial mortgage. The non-profit child care centers provide the same quality of care as the for-profit centers. Preventing non-profit child care centers from making use of the SBA 504 program when their for-profit competitors are able to do results in discrimination against the children they serve; and, in general, the majority of child care centers operating in our state's neediest areas are non-profit.

For these reasons, I would like to support your efforts to expand the SBA 504 program enabling non-profit child care centers to be eligible for fixed asset financing under the 504 program. Thank you for your efforts.

Sincerely,

Heather Danton
Vice President

BYRON L. DORGAN
NORTH DAKOTA
713 HART BUILDING
WASHINGTON, DC 20510-3405
202-224-2551
202-224-9379 TDD

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**United States Senate**

WASHINGTON, DC 20510-3405

STATE OFFICES

312 FEDERAL BUILDING
THIRD AND ROSSER AVENUE
P.O. BOX 2579
BISMARCK, ND 58502
701-250-4618
1-800-666-4482 TOLL-FREE

112 ROBERTS STREET, ROOM 110
P.O. BOX 2250
FARGO, ND 58107
701-239-5389

102 NORTH 4TH STREET, ROOM 108
GRAND FORKS, ND 58201
701-746-8972

100 1ST STREET, S.W., ROOM 105
MINOT, ND 58701
701-852-0703

April 29, 2003

The Honorable Olympia J. Snowe
Chairman
Senate Committee on Small Business and Enterpreneurship
United States Senate
SR-428A
Washington, DC 20510

Dear Madam Chairman:

I understand that you will be chairing a Roundtable on the reauthorization of Small Business Administration's (SBA) Credit Programs on Thursday, May 1, 2003. At this time, your Committee will be considering issues related to the SBA's disaster loan program, and I have attached some written testimony related to this program for the Committee's consideration.

As you may know, I have been concerned in recent years with the SBA's Asset Sale program, particularly with respect to the sale of disaster loans to private companies. In 2001, I started getting complaints from North Dakotans about this program. Homeowners and businesses that had their disaster loans sold to private companies were having great difficulty when they tried to sell their home or upgrade their assets to make their businesses more efficient. While the companies were sticking to the terms of the SBA loan with respect to the interest rate and time, they have not been nearly as flexible as the SBA has always been in substituting collateral and other issues. This has caused great difficulty for many people in my state who have used the SBA's disaster loan program.

My testimony further outlines my concerns about borrower protections, and I hope the Committee will take these concerns into careful consideration during this reauthorization of SBA's credit programs.

Sincerely,

Byron

Byron L. Dorgan
U.S. Senator

BLD:njk
Enclosure

**Statement of Senator Byron L. Dorgan**
**Submitted to the Committee on Small Business and Entrepreneurship**

**Roundtable: SBA Reauthorization: Credit Programs (Part II)**

**May 1, 2003**

Madam Chair, Senator Kerry and Members of the Committee:

Thank you for the opportunity to submit my concerns to the Roundtable about the Small Business Administration's Asset Sale program. I look forward to working with the Members of the Committee during this reauthorization to address a major problem with the Small Business Administration's Asset Sale Program.

Several years ago, the SBA packaged up a series of disaster loans that it made, and sold them with deep discounts to financial companies around the country. The representation to the American people and to the Congress was that this would not impact their loans at all. The SBA wanted to sell these loans so that it would not have to do the loan servicing, thereby saving the taxpayer these costs.

That sounded benign enough to almost everybody in the country. So the SBA conducted six sales, beginning in August 1999, and sold many loans in its portfolio, including disaster loans. As of January 2002, approximately 85% of the loans SBA sold were direct disaster assistance loans, most of which have below-market interest rates.

Let me describe the impact of the sale of those disaster loans in North Dakota. Most Americans will remember the great flood in the Red River Valley in 1997, when the entire city of Grand Forks, ND, with nearly 50,000 residents, had to evacuate. The city was inundated with floodwaters from the Red River. In the middle of the flood, after the entire city had been evacuated, a fire started in the downtown area of the city. Fire trucks tried to get into the evacuated city on flatbeds to fight a fire in the center of downtown Grand Forks.

It was a devastating time for the people of Grand Forks. When the waters receded, most homeowners and business men and women of Grand Forks came back to their homes and businesses to find severe damage. They found massive damage in buildings all across this city.

The city, of course, was helped by FEMA, the SBA and other agencies of the Federal Government. President Clinton came to Grand Forks and said: "You're not alone. The American people are with you. The American people want to help you. And, indeed, the American people did."

This Congress was generous to the communities along the Red River Valley and to Grand Forks especially. Grand Forks and East Grand Forks were hit very hard, and they required a substantial amount of help.

In order to get back on their feet, many businesses and families took a low interest SBA disaster loan. It provided them with a 4 percent loan over a rather lengthy term. I strongly support the SBA's disaster loan program because of its ability to help families and businesses get back on their feet after a natural disaster.

After these businesses and homeowners were able to get the loans, the SBA began its Asset Sale program. Private financial companies bought a batch of loans for between 40 and 70 cents on the dollar for the loans and assumed the responsibility for servicing the loans. The letters borrowers received from the SBA indicated that nothing would be different, although SBA would no longer service their loans.

Sometime in 2001, I started getting complaints about this program. Borrowers discovered that their disaster loans are now being serviced by private companies who are primarily concerned with getting payment as quickly as possible, even if it means financial ruin for the borrowers. For example, the companies that bought these disaster loans no longer allow borrowers to substitute collateral. If they do, they are forced to pay

a very substantial fee. Collateral substitution is routinely allowed by the SBA. These private companies have also decided that they want to enforce provisions, such as Supplemental Annual Payment provisions, that the SBA seldom enforced on disaster victims trying to get back on their feet. In other words, while the companies were sticking to the strict terms of the SBA loan with respect to the interest rate and time, they have not acted as the SBA has always has acted when servicing disaster loans.

Let me just mention a couple people. There is a woman named Marie from Grand Forks, ND, who wrote me and said: "I'm another flood victim trying to deal with the loan I took out from the SBA. My SBA loan was sold to Aurora Loan Services, and I have been told by Aurora they don't transfer loans, period. So essentially I'm out of luck. Personal circumstances made it necessary for me to sell my property, and I need this low interest rate in order to be able to afford another property and get back on my feet."

A man named Steven also wrote to me. He is a businessman in Grand Forks, ND. He said: "I'm an optometrist. In the flood of 1997, our office received 5 feet of water. Pretty much a total loss. We see the opportunity to borrow money at 4 percent for 30 years as a gift from the American people. Nobody was going to make our community whole overnight, but these loans over 30 years, would go a long way in helping." Then he describes his need to have flexibility to purchase additional assets and the difficulty he has had trying to negotiate with the company that purchased the loan. They have simply said: No way.

I share these stories to point out that there is something wrong with this process. The General Accounting Office (GAO) also discovered these problems in a report that it delivered to the Committee last January. I was not surprised to see in the report that "the lack of a comprehensive process for identifying borrower inquiries and complaints suggests that SBA may be unable to adequately enforce borrower protections." It also noted that the "agency may not know how many complaints have actually been registered or whether some private lenders' actions are in conflict with SBA's public policy goals." Besides inadequate borrower protections, the GAO report also identifies other problems

in the Asset Sale program. For example, it noted that faulty accounting and reporting methods obscure the actual financial and budgetary impact of the loan sales.

I urge the Committee to take a close look at this GAO report as it reauthorizes SBA's credit programs. I believe that the SBA ought not sell disaster loans. SBA should service those loans and do so in a thoughtful and rational way.

I recently wrote to Administrator Barreto, asking him what actions he is planning to take to protect borrowers. The letter I received in response on March 21st indicated that while it will try to do a better job in tracking complaints, it will take no action to remedy problems that occur after loans are sold. I do not think this is an adequate response to the problems identified in the GAO report.

As the Committee reauthorizes the disaster loan program, I urge you to consider the purpose of this program. The government may not make a lot of money on these loans, but the purpose of the program is not to make money, but to help people. The private sector is in business to make money. So I don't think the private sector should be servicing these types of loans. This should be a public service for those who suffer disasters in our country. I hope you will agree that those who have been hit with disaster in this country don't deserve to be handcuffed later by a private company that is able to buy deeply discounted SBA disaster loans. This is not the right thing to do to the citizens of this country who have suffered through a disaster. We can do better. I hope we will.

JUL-22-2002 14:16 FROM:NC WASHINGTON OFC 2026245836 TO:92281814 P:2/3

Jul-18-02 11:20 From- T-548 P.03/15 F-852

**STATE OF NORTH CAROLINA**
**OFFICE OF THE GOVERNOR**
**20301 MAIL SERVICE CENTER • RALEIGH, NC 27699-0301**

MICHAEL F. EASLEY
GOVERNOR

July 18, 2002

The Honorable John Edwards
United States Senate
225 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Edwards:

I am writing to thank you for your support for legislation introduced in the Senate to add drought as a condition for which small businesses may apply for Small Business Administration Economic Injury Disaster Loans.

The Small Business Drought Relief Act (S.2734) will correct the current situation facing our small businesses in North Carolina. SBA disaster assistance is not available despite a historic drought that is impacting not just our agriculture sector, but causing real business and revenue losses, which threaten some firms with job layoffs or even bankruptcy.

These businesses need help, and access to low-interest SBA loans can offer a lifeline to allow paying bills and making payrolls until business returns to normal.

I urge you to push for rapid action on this important enhancement to SBA's ability to help our people through this time of trouble.

With kindest regards, I remain

Very truly yours,

Mike Easley

Michael F. Easley

MFE/jm

**ACCION USA**

The Honorable John Kerry
Chairman
Senate Committee on Small Business and Entrepreneurship
428A Russell Senate Office Building
Washington, DC 20510

July 8, 2002

Dear Senator Kerry:

My name is Erika Eurkus, and as a member of your Advisory Committee on Child Care and Small Business, I writing to voice my support of expanding the SBA 504 loan program to include nonprofit child care centers.

I am the greater Boston program director for ACCION USA, a nonprofit "micro" lender whose mission is to make access to credit a permanent resource to low- and moderate-income small business owners in the United States – helping to narrow the income gap and provide economic opportunity to small business owners throughout the country. Many of the struggling entrepreneurs we serve are the owners of small, family-based day care centers.

At ACCION, I regularly come into contact with women and men whose dream is to operate a successful child care center – to provide a service to the community while making a better life from something they love to do. Often, what keeps these hardworking entrepreneurs from fully realizing that dream is a lack of working capital to begin and grow their businesses. Microlenders like ACCION are the only place they can turn for the crucial capital they need for their businesses. Mauro Leija, an ACCION client in San Antonio, Texas, has tried – and failed – to secure capital from commercial banks. "The loan officer at the bank said, 'Be realistic – you'll never get a loan. You have no college diploma, no capital, no history with any bank,'" Mauro remembers. This lack of economic opportunity is too often the reality for countless child care providers – most of whom earn an average of $3 per hour for their services.

With increased access to capital through the expansion of the SBA 504 loan program, small, nonprofit day care centers can continue to provide their valuable services to the community – and build a better life for their own families at the same time. Suzanne Morris of Springfield, Massachusetts, a longtime ACCION USA borrower, already illustrates the potential successes that an expanded SBA 504 – and an opportunity for capital – will bring to day care owners across the country. After years of hard work and several small loans from ACCION, Suzanne has moved her day care out of the home and has expanded her staff to include seven members of the community. The business supports her family of four. She also gives back by training other local home-based day care providers in federal nutrition guidelines.

It is my hope that we can all witness more successes like those of Suzanne by opening the door to funding for small day care providers. Please include nonprofit child care centers in the scope of SBA 504.

Sincerely,

Erika Eurkus
Greater Boston Program Director

56 Roland Street Suite 300 Boston, MA 02129 (t) 617-625-7080 (toll-free) 1-866-245-0783 (f) 617-625-7020 www.accionusa.org

OFFICE OF THE GOVERNOR

KENNY C. GUINN
Governor

July 23, 2002

The Honorable John F. Kerry
Chairman
Committee on Small Business
428-A Russell Building
Washington, DC 20510

The Honorable Christopher Bond
Ranking Member
Committee on Small Business
428-A Russell Building
Washington, DC 20510

Dear Senators Kerry and Bond:

Much of Nevada and the Nation have been experiencing extreme drought over the past several years. In Nevada we have seen the effects of this situation through catastrophic range and forest fires, insect infestations and loss of crops and livestock.

Prolonged drought causes a drastic reduction in stream and river flow levels. This can cause the level of lakes to drop so significantly that existing docks and boat ramps cannot provide access to boats. In the case of range and forest fires we have seen small innkeepers and hunting and fishing related businesses that have their entire season wiped out in a matter of a few hours.

Unfortunately for some small businesses, drought assistance is available only for agriculture related small businesses, such as feed and seed stores. For businesses that are based on tourism around lakes and rivers, there is currently no drought assistance available.

The Small Business Administration (SBA) is not currently authorized to help these businesses because a drought is not a sudden occurrence. Nonetheless, a drought is an ongoing natural disaster that causes great damage to these small businesses.

I would like to lend my support to S. 2734, The Small Business Drought Relief Act. This bill would amend the guidelines and authorize the SBA to offer assistance to small businesses affected by prolonged drought. With passage of this bill, Governors would be allowed to ask SBA for an administrative declarations of economic injury because of drought. The low interest loans SBA can offer these businesses would allow many of them to weather the drought and remain economically viable for future operation.

101 N. CARSON STREET • CARSON CITY, NEVADA 89701 • TELEPHONE: (775) 684-5670 • FAX: (775) 684-5683
555 E. WASHINGTON AVENUE, SUITE 5100 • LAS VEGAS, NEVADA 89101 • TELEPHONE: (702) 486-2500 • FAX: (702) 486-2505

Sincerely,

Kenny C. Guinn
Governor

cc: Senator Harry Reid
Senator John Ensign

# State of South Carolina

## Office of the Governor

JIM HODGES
GOVERNOR

POST OFFICE BOX 11829
COLUMBIA 29211

July 9, 2002

The Honorable John Kerry
United States Senate
304 Russell Building, Third Floor
Washington, DC 20510

Dear Senator Kerry:

The State of South Carolina is in its fifth year of drought status, the worst in over fifty years. Some parts of the state are in extreme drought status and the rest is in severe drought status.

99% of our streams are flowing at less than 10% of their average flow for this time of year. 60% of those same streams are running at lowest flow on record for this date. The levels of South Carolina's lakes have dropped anywhere from five feet to twenty feet. Some lakes have experienced a drop in water level so significant that tourist and recreational use has diminished.

State and national climatologists are not hopeful that we will receive any significant rainfall in the near future. To end our current drought, we would need an extended period of average to above average rainfall.

Droughts, particularly prolonged ones such as we are experiencing now, have extensive economic effects. For farmers who experience the economic effects of such a drought, assistance is available through the USDA. For small businesses, assistance is available only for agriculture related small businesses, i.e. feed and seed stores. For businesses that are based on tourism around Lakes and Rivers, there is currently no assistance available.

We have reports of lake and river tourism dependent businesses experiencing 17% to 80% declines in revenue. The average decline in revenue is probably near 50% across the board.

My staff has contacted Small Business Administration and they are not authorized to offer assistance to these businesses because a drought is not defined as a sudden occurrence. Nonetheless, a drought is an ongoing natural disaster that is causing great economic damage to these small business owners.

The Honorable John Kerry
Page 2

I am requesting that you assist us in this situation by proposing that the Small Business and Entrepreneurship Committee take action to at least temporarily amend the SBA authorizing language and allow them to offer assistance to small businesses affected by prolonged drought. This would allow Governors to ask SBA for an administrative declaration of economic injury because of drought. The low interest loans SBA can offer these businesses would allow many of them to weather the drought and remain in business for the long run.

My staff has also been in contact with Senator Hollings' legislative staff. I hope together, we can find an expedient solution to the plight of these small business owners. Short of finding a way to control the weather, this may be our only option to help their dire situation.

Sincerely,

Jim Hodges

Jim Hodges

**Statement of Senator John F. Kerry**
**Committee on Small Business & Entrepreneurship**
**Roundtable on Reauthorization of SBA's Loan & Venture Capital Programs**
**May 1st, 2003**

Good morning. Thank you all for being here, particularly those who are pulling double duty, participating for the second day in a row. As I said yesterday, I encourage all of you to use this format to air the issues affecting these critical loan and venture capital programs and to have a healthy and constructive dialogue with us. Chair Snowe, I again thank you for holding these roundtables to review the SBA's loan and venture capital initiatives.

Yesterday the Committee built a very good record on the needed changes and demands of the 7(a) Loan Guarantee Program and the Microloan Program. Today we will review the Certified Development Company or 504 Loan Guaranty Program, the Disaster Loan Program, the New Markets Venture Capital (NMVC) Program, and the Small Business Investment Company (SBIC) Program. Of course, the priority for the Certified Development Companies (CDCs) that make 504 loans is reauthorization of the 504 program before it expires on September 30th. No matter how good the intentions of our side and the House Committee on Small Business to pass reauthorization bills on time, on occasion, a small business bill gets saddled with extraneous controversial provisions that delay passage. This program spurs business investment, which is sorely missing from our economic recovery, and creates jobs. I pledge to work with Chair Snowe to pass this year's SBA reauthorization bill by September 30th.

As part of reauthorization of the 504 program, I urge the Committee to include the Child Care Lending Pilot of Act 2003, which would make it possible for eligible non-profit child care providers to receive 504 loans to establish, improve or expand facilities. We have a shortage of good childcare facilities in this country, and it is a problem for our families, a problem for our businesses, and a problem for our economy. The 504 program could increase the number of providers available for the working moms and dads.

The Census Bureau estimates that there are approximately 24 million school age children with parents who are in the workforce or pursuing education, and the numbers are growing. In Massachusetts alone, where non-profit child care centers make up more than 60 percent of all providers and serve families who receive child care subsidies, 20,000 children are waiting for assistance to receive care. With more capacity, we could make sure those kids have a clean, safe and affordable place to go while their parents are at work. I thank the many senators who have cosponsored this bill and ask Committee Chair Snowe to cosponsor this bill and to work with me to include the bill in the reauthorization package. I also ask unanimous consent for several letters of support from lenders and child advocates be included as part of the record.

The disaster loan program has helped millions of homeowners and business owners in this country over the years. It was critical in helping the nation to recover from the terrorist attacks of September 11th, 2001, and I thank Herb Mitchell and his team for all the help they've provided to thousands of disaster victims throughout the country.

As important as this program is, I have some concerns that I would like addressed as part of SBA's reauthorization. One is the sale of disaster loans in SBA's asset sales. Members of the Senate and House have raised concerns with the SBA for several years about this policy, questioning whether it is appropriate to sell these loans and how to address complaints from disaster loan borrowers who feel they have been harassed and treated unfairly by the companies that buy the loans. A frequent example arises when a borrower seeks to restructure his or her disaster loan on a home when refinancing the home mortgage in this low-interest rate market. The holders of the loans are reportedly inflexible when borrowers ask for changes. SBA has diminished the number and severity of complaints raised and the Administration has blocked Congressional attempts to put moratoriums on the loans, arguing that the complaints are very few in proportion to the tens of thousands of loans sold. However, as GAO can confirm at today's roundtable, SBA did not track all complaints, only those from Congress, and so it does not have an accurate assessment of the severity of the problem. Further, GAO found that most of the disaster loans being sold are performing, that is, the borrowers are paying the amount owed plus interest when it comes due. This is counter to SBA's claims that the asset sales were to shed the Agency of poor performing or non-performing loans that require a disproportionate amount of staff time to handle. I recommend that the moratorium on the sale of disaster loans be kept in place until SBA can address the concerns GAO identified in its study, as well as those raised by Congress and borrowers. I request that if SBA plans to start asset sales again, that it notify its oversight Committees immediately.

Further, as part of reauthorization, I recommend requiring the SBA to adopt electronic fingerprinting to run background checks on all SBA loan applicants, and particularly on those applying for disaster loans. Disaster loans are especially time-sensitive to the applicants, and they cannot and should not have to wait months for a review because they submit paper fingerprints when electronic fingerprints can be processed in 48 hours or less according to the FBI. The technology exists and has been in use for other Federal departments for a couple of years, so SBA should try to adopt this system as soon as possible.

Last, I would like to see the Small Business Drought Relief Act of 2003 included in the reauthorization package. I thank you, Chair Snowe, and Senator Bond for joining me in passing this common-sense bill in the Senate . It has bi-partisan support both in Congress and among governors. The Administration has approved the bill, and it has been voted out of the Senate by unanimous consent. I ask that several letters of support from individual governors and the Southern Governor's Association be placed in the reauthorization record.

Today we will also review SBA's venture capital programs, the Small Business Investment Company (SBIC) program and the New Markets Venture Capital program. I look forward to hearing recommendations from the National Association Small Business Investment Companies regarding the adjustment they need to their fee formula to accommodate an increased subsidy cost projected by OMB for FY2004 and for potential future increases. Their role in our economy continues to be important as traditional venture capital has all but disappeared, shrinking from \$106 billion in 2000 to only \$6 billion in 2002. We need equity for our fastest growing and most revolutionary small businesses because they are the biggest job creators. Luckily, SBICs continue to make more than 50 percent of all venture capital deals in the United States .

Last, but certainly not least, the Committee will also review the New Markets Venture Capital program. I thank Committee Chair Snowe for her support of this innovative venture capital initiative over the past years and look forward to working with her improve the management of resources devoted to it at the Agency.

However, the first priority is for SBA to complete its review of the remaining conditionally approved New Markets Venture Capital companies as soon as possible. I call on SBA's Office of General Counsel to make this a priority. It is unacceptable that SBA criticized the NMVC firms for not raising their matching private capital when, in reality, these applicants had raised their money and submitted their proposals and it was SBA's delay in the review process that prevented their final approval. Enough finger pointing and delay. Small businesses in need of this type of venture capital are the ones suffering from the broken process. I call upon Administrator Barreto to make this a priority and promptly review the remaining applications. SBA should be able to handle the review of seven firms if they can handle the licensing of 13 new SBICs this year.

Next, I would like the $24 million entrusted to SBA for a second round of New Markets Venture Capital funding restored. This initiative has great potential to spur local job creation and economic activity of fast growing small-businesses in the nation's poorest rural and urban areas - areas overlooked by traditional venture capitalists. As reported Monday in the "CBS Market Watch" article, the Administration is being penny-wise and pound-foolish in cutting programs like this when the economy needs all the help it can get.

Madam Chair, I thank you and your staff for all your work in reauthorizing the SBA's programs and for your collaborative spirit. To all the participants, thank you again for participating in the Committee's roundtables this week, and please let us hear your comments, your concerns and your recommeded changes now, or in writing for the reauthorization record. We want SBA's programs to continue to improve and evolve for the best of small businesses and the nation's economy. I ask that my statement be included in the record.

JUL 2002
JW

**Neighborhood Business Builders**
*a small business assistance program*

Chairman Senator John Kerry
Senate Committee on Small Business and Entrepreneurship
428A Russell Building
Washington DC 20510

7/10/02

Dear Chairman Senator Kerry,

I am writing on behalf of Neighborhood Business Builders and the Jewish Vocational Service of Boston in support of legislation to expand availability of SBA 504 loans to non-profit child care centers.

I am currently the Director of Loan Funds at Neighborhood Business Builders, which is an economic development program and US SBA Intermediary Microlender. I have been lending and consulting to small businesses for the past year after fifteen years in the private sector as founder of three different companies in Boston and Los Angeles. I have an MPA from the Kennedy School at Harvard University.

I am on Senator Kerry's Child Care and Small Business Advisory Committee, and am Co-chair of the Sub Committee on Family Child Care.

I support legislative change to the 504 loan program because our committee has uncovered a need for government support of non-profit child care centers. The basic reason for this is that, while we recognize a demand for child care in every part of the country, we do not consider that the market fails to *profitably* supply child care in every part of the country.

For-profit entities are able to access the capital they need by (1) Demonstrating demand for the service provided and (2) Demonstrating ability to service market rate debt with acceptable risk. Non-profit centers emerge when (1) Demonstrated demand for the service is evident but (2) The market will not support the true cost of the service provided. These non-profit centers are unable to access traditional forms of capital because they cannot demonstrate an ability to service debt at an acceptable risk.

The SBA 504 loan program would help mitigate the risk to lenders who will then be able to provide the necessary capital for the service that we know is in demand. The tax status of a child care center should be irrelevant, since the 501(C)3 status is only granted when there is evidence of a public good being provided.

Sincerely,

Eric Korsh
Director of Loan Funds, Neighborhood Business Builders

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105 Chauncy Street, 6th floor, Boston, MA 02111
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Senator John Kerry, Chairman
Senate Committee on Small Business and Entrepreneurship
428A Russell Building
Washington, DC 20510

July 3, 2002

Dear Senator Kerry,

It has come to my attention that your committee is working on legislation that would expand the SBA 504 loan program to non-profit child care centers.

As the Executive Director of the Guild of St. Agnes Child Care Agency and a member of the Advisory Committee on Child Care and Small Business, I wholeheartedly support this legislation. The Guild of St. Agnes is a non-profit child care agency providing child care in Worcester, MA and its surrounding towns. Presently we care for 1200 children aged four weeks to twelve years in child care centers, family care provider's home and public schools. Of our seven centers, we currently own one..

Four of our centers are in old, worn-down buildings, causing us difficulty in recruiting new clients. As we look towards the future, the Guild of St. Agnes has set a goal of replacing these centers with new buildings. In order to accomplish this goal, we need to look for creative funding sources to support our capital campaign. The SBA 504 loan program would allow us to invest 10% of our own funds for capital expenses, borrow 50% from the government and secure a bank loan for 40%. Not only is this loan program attractive to banking institutions, it allows child care agencies like the Guild of St. Agnes to continue to grow during these economically challenging times.

I urge you to support the SBA 504 loan program legislation. The future of non-profit child care agencies such as the Guild of St. Agnes depends on it!

Sincerely,

Edward P Madaus

Edward P. Madaus
Executive Director

Center Locations: Ayer • Bellingham • *Fitchburg • Gardner • *Granite Street, Worcester • Grove Street, Worcester • Lincoln Street, Worcester
Family Child Care Location: Devens • Spencer • Whitinsville • Worcester

*Supported in part by United Ways in Worcester County and the Commonwealth of Massachusetts.*
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COMMONWEALTH OF KENTUCKY
OFFICE OF THE GOVERNOR

PAUL E. PATTON
GOVERNOR

700 CAPITOL AVENUE
SUITE 100
FRANKFORT, KY 40601
(502) 564-2611
FAX: (502) 564-2517

July 23, 2002

The Honorable John F. Kerry
Chairman
Committee on Small Business
& Entrepreneurship
United States Senate
428A Russell Senate Office Building
Washington, D.C. 20510

The Honorable Christopher S. "Kit" Bond
Ranking Member
Committee on Small Business
& Entrepreneurship
United States Senate
428A Russell Senate Office Building
Washington, D.C. 20510

Dear Chairman Kerry and Senator Bond:

As you know, much of our nation is struggling to overcome "moderate" to "extreme" drought conditions. Droughts, especially prolonged droughts, have extensive, devastating effects that damage crops and livestock, deteriorate soil, and fuel raging wildfires. These are only some of the irreparable effects that droughts can have on small businesses, communities, and state and local economies.

In general, federal disaster assistance is available for agriculture and agriculture-related small businesses that are impacted by drought. However, droughts hurt more than agricultural, forestry, and livestock businesses.

Prolonged drought also causes a drastic reduction in stream and river flow levels. This can trigger such a significant drop in the level of lakes that existing docks and boat ramps cannot provide access to boats, which impacts many additional small businesses.

As a result, many non-farm small businesses that are water-reliant also suffer staggering revenue losses in the wake of a drought disaster, yet they do not currently receive disaster relief. Unlike other natural disasters such as hurricanes or floods, the effects of drought build up over-time, last for several years, and are jeopardizing the future of these small business owners. The lack of federal disaster assistance available to these non-farm small businesses only forces undue job layoffs and bankruptcies and further disrupts drought-impacted communities.

THE HONORABLE JOHN F. KERRY
THE HONORABLE CHRISTOPHER S. "KIT" BOND
July 23, 2002
Page 2

I thank you for recognizing that many fish and tackle shops, rafting businesses, restaurants, motels, camp grounds, marinas, gas stations, and other small businesses in Kentucky and other states are severely impacted by drought but are unable to receive federal disaster assistance. I strongly support your resulting efforts, the *Small Business Drought Relief Act* (S. 2734), which would allow the Small Business Administration to offer low-interest disaster loans to these businesses and afford them the same opportunity as agriculture-related businesses to recover and survive.

I appreciate your assistance and support and look forward to working with you and your colleagues on this very important matter.

Sincerely,

Paul E. Patton

Paul E. Patton

cc: The Honorable Mitch McConnell, United States Senate
The Honorable Jim Bunning, United States Senate
The Honorable Harold Rogers, U. S. House of Representatives
The Honorable Ernie Fletcher, U. S. House of Representatives
The Honorable Ron Lewis, U. S. House of Representatives
The Honorable Ken Lucas, U. S. House of Representatives
The Honorable Anne Northup, U. S. House of Representatives
The Honorable Ed Whitfield, U. S. House of Representatives

wmef western massachusetts enterprise fund, inc.

July 12, 2002

Senator John Kerry
Chairman
Senate Committee on Small
Business and Entrepreneurship
428A Russell Office Building
Washington, DC 20510

Dear Senator Kerry:

I am writing in strong support of the legislation to expand the use of the SBA 504 program to include the financing of non-profit childcare centers.

As a member of Senator Kerry's Childcare Advisory Committee and the Executive Director of the Western Massachusetts Enterprise Fund (which makes loans to non-profits), I have seen a clear need for both more flexible and lower cost financing.

The SBA 504 program meets both those needs. By providing up to 40 percent financing, the SBA 504 program can help childcare centers more easily leverage bank financing. Additionally, the program offers highly competitive interest rates.

Finally, allowing the SBA to make loans to non-profit childcare centers is not new to the agency. The SBA is already making working capital loans to non-profit childcare centers through its Microenterprise Loan Fund Program.

If you have any questions, please do not hesitate to contact me.

Sincerely,
Christopher Sikes
Christopher Sikes
Executive Director

P.O. Box 1077, Greenfield, MA 01302
E-mail: mail@wmef.org • Web Site: www.wmef.org
Greenfield Office: 308 Main St., Suite 2-B • Voice: 413 774-4033 • Fax: 413 774-3673
Springfield Office: Springfield Enterprise Center, STCC, 1 Federal St. Bldg. 101-R • Voice: 413 739-6300 • Fax: 413 739-6800

*Creating Ripple Effects by Expanding Economic Opportunities in Western Massachusetts*

SOUTHERN
GOVERNORS' ASSOCIATION



August 19, 2002

The Honorable John Kerry
U.S. Senate
304 Russell Senate Office Building
Washington, DC 20510

Dear Senator Kerry:

We are deeply concerned that small businesses in states experiencing drought are being devastated by drought conditions that are expected to continue through the end of the summer. We urge you to support legislation that would allow small businesses to protect themselves against the detrimental effects of drought.

Much like other natural disasters, the effects of drought on local economies can be crippling. Farmers and farm-related businesses can turn in times of drought to the U.S. Department of Agriculture. However, non-farm small businesses have nowhere to go, not even the Small Business Administration (SBA), because their disaster loans are not made available for damage due to drought.

To remedy this omission, Sen. John Kerry (D-Mass.) introduced the Small Business Drought Relief Act (S. 2734) on July 16, 2002, to make SBA disaster loans available to those small businesses debilitated by prolonged drought conditions. This bill was passed by the Senate Small Business Committee just eight days later. Also, the companion legislation (H.R. 5197) was introduced by Rep. Jim DeMint (R-S.C.) on July 24, 2002. Both bills are gaining bipartisan support, and we hope you will cosponsor this important legislation and push for its rapid enactment in the 107th Congress.

As 11 southern states are presently experiencing moderate to exceptional drought conditions this summer, we cannot afford to wait to act. We urge you to cosponsor the Small Business Drought Relief Act and push for its consideration as soon as possible.

Sincerely,

| | |
|---|---|
| Gov. Don Siegelman of Alabama | Gov. Mike Huckabee of Arkansas |

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SGA Small Business Drought Letter
August 19, 2002
Page 2

Roy E Barnes
Gov. Roy E. Barnes of Georgia

Paul E. Patton
Gov. Paul E. Patton of Kentucky

M. J. Foster
Gov. M.J. "Mike" Foster, Jr. of Louisiana

Parris N. Glendening
Gov. Parris N. Glendening of Maryland

Ronnie Musgrove
Gov. Ronnie Musgrove of Mississippi

Bob Holden
Gov. Bob Holden of Missouri

Mike Easley
Gov. Michael F. Easley of North Carolina

Gov. Frank Keating of Oklahoma

Jim Hodges
Gov. Jim Hodges of South Carolina

Don Sundquist
Gov. Don Sundquist of Tennessee

Rick Perry
Gov. Rick Perry of Texas

Mark R Warner
Gov. Mark Warner of Virginia

Bob Wise
Gov. Bob Wise of West Virginia